S. HRG. 99-597

FARM CREDIT ADMINISTRATION ACT AMENDMENTS OF 1985

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

ON

THE BANK REGULATORS AND AGENCIES ANALYSES OF THE EFFECT THE FARM CRISIS HAS HAD ON FINANCIAL INSTITUTIONS PRIMARILY ENGAGED IN AGRICULTURAL LENDING AND TO DETERMINE WHAT ACTION IS NECESSARY TO AID THOSE FINANCIAL INSTITUTIONS DURING THIS TRANSITION PERIOD

MARCH 6 AND 11, 1986

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

U.S. GOVERNMENT PRINTING OFFICE

59-527 O WASHINGTON : 1986

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S241-26

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

JAKE GARN, Utah, *Chairman*

JOHN HEINZ, Pennsylvania
WILLIAM L. ARMSTRONG, Colorado
ALFONSE M. D'AMATO, New York
SLADE GORTON, Washington
MACK MATTINGLY, Georgia
CHIC HECHT, Nevada
PHIL GRAMM, Texas

WILLIAM PROXMIRE, Wisconsin
ALAN CRANSTON, California
DONALD W. RIEGLE, JR., Michigan
PAUL S. SARBANES, Maryland
CHRISTOPHER J. DODD, Connecticut
ALAN J. DIXON, Illinois
JIM SASSER, Tennessee

M. DANNY WALL, *Staff Director*
KENNETH A. MCLEAN, *Minority Staff Director*

CONTENTS

THURSDAY, MARCH 6, 1986

	Page
Opening statement of Chairman Garn	1
Opening statements of:	
Senator Heinz	2
Senator Dixon	3
Senator Mattingly	4
Prepared statement	5
Senator D'Amato	5
Senator Proxmire	15

WITNESSES

Charles E. Grassley, U.S. Senator from the State of Iowa	6
"Midwest's Farm Crisis Reaches East," article from New York Times	6
Review of the farm crisis	8
James Abdnor, U.S. Senator from the State of South Dakota	10
High time to focus on solutions	10
Terry L. Bruce, U.S. Representative in Congress from the State of Illinois	12
Amortize loan payments over 10-year period	12
Prepared statement	14
Panel discussion:	
Ten-year provision	16
Robert Dole, U.S. Senator from the State of Kansas	18
Opposed to buydown program	18
Expanded FDIC authority	19
Prepared statement	21
Stabilizing bank capital	23
Expanded FDIC authority to prevent bank closings	24
More buyers of troubled institutions	24
Conclusion	24
Charles O. Sethness, Assistant Secretary for Domestic Finance, Department of the Treasury	27
Fed reports 80 to 85 percent of farmers are in good shape	27
Aspects of the 1985 act	28
Relief from the FHA	30
Prepared statement	32
Financial problems of agricultural banks	32
Farm Credit Amendments Act of 1985	33
Benefits of the Farmers Home Administration programs	34
Proposed special assistance programs for agricultural banks	35
Conclusion	36
Witness discussion:	
Secondary market for farm loans	37
Extension of Net Worth Certificate Program	38
Oversight Board for FHA	40
Board appointments are passed due	41
Randall A. Killebrew, president, First National Bank, Petersburg, IL; vice chairman, American Bankers Association's Government Relations Council, accompanied by Michael E. Fitch, vice president for agribusiness affairs, Wells Fargo Bank, San Francisco, CA	43
Burdens on farm-related entities	43
Amortization of loan losses	45
Prepared statement	46

Page

Randall A. Killebrew, president, First National Bank, Petersburg, IL; vice chairman, American Bankers Association's Government Relations Council, accompanied by Michael E. Fitch, vice president for agribusiness affairs, Wells Fargo Bank, San Francisco, CA—Continued
Prepared statement—Continued
I. Stabilization of bank capital ... 48
II. Stabilization of agricultural borrowers ... 49
III. Stabilization of farm real estate values ... 50
Conclusion ... 51
B.F. "Chip" Backlund, president, Bartonville Bank, Peoria, IL; president, Independent Bankers Association of America ... 53
$2.7 billion charged off in 1985 ... 53
Stabilize bank capital ... 54
Ability to enhance a stronger customer base ... 55
Prepared statement ... 57
Recommendations of the ABA-1BAA task force on agricultural credit ... 61
Leslie G. Horsager, vice president, Prudential Life Insurance Co., on behalf of the American Council of Life Insurance ... 63
Providing $12 billion in farm mortgages ... 63
Prepared statement ... 65
Background ... 65
The current situation ... 66
The long term ... 67
Rudy Boschwitz, U.S. Senator from the State of Minnesota ... 70
Interest rates are still at 13.9 or 14 percent ... 70
Panel discussion:
Time period for writeoffs ... 72
Implementing regulations ... 73
Continued participation ... 74
Falling farm exports ... 75
Bankers and farmers are a team ... 77
Prefer Loan Loss Deferral Program ... 78
Benefits to the borrower ... 79
Longer period allows greater comfort level ... 80

TUESDAY, MARCH 11, 1986

Opening statement of Chairman Garn ... 83
Opening statements of:
Senator Heinz ... 84
Senator D'Amato ... 155

WITNESSES

Don Nickles, U.S. Senator from the State of Oklahoma ... 85
Bank failures ... 85
List of Oklahoma bank failures 1982-86 ... 86
John Melcher, U.S. Senator from the State of Montana ... 88
Dilemma of low income for farmers ... 88
Assistance from the Federal Reserve ... 90
Prepared statement ... 90
J. James Exon, U.S. Senator from the State of Nebraska ... 91
Programs to assist troubled farmers ... 92
L. William Seidman, Chairman, Federal Deposit Insurance Corporation ... 94
468 farm banks on problem list ... 95
Favor revising reporting requirements ... 96
Modified procedures in handling bank failures ... 97
Prepared statement ... 99
Robert L. Clarke, Comptroller of the Currency ... 104
Uncertain conditions in agricultural economy ... 104
FASB-15 as a tool ... 105
Capital forbearance as superior ... 106
Need to diversify ... 108
Prepared statement ... 110
Profile of agricultural banks ... 110
The OCC's proposal ... 112

Page

Robert L. Clarke, Comptroller of the Currency—Continued
Prepared statement—Continued
FASB 15 113
Capital forbearance 113
Other needed measures 116
Actions needed by Congress and State governments 117
Actions needed by agricultural banks 119
Conclusion 120
Letter of issuance of FASB-15 to the banks 140
Preston Martin, Vice Chairman, Board of Directors, Federal Reserve System, accompanied by William Taylor, Director, Division of Banking Supervision and Regulation 121
Desperate farm situation 121
Proposals for restructuring debt 123
Easing interstate banking laws 124
Prepared statement 126
Debt restructuring 128
Net worth certificates and loan loss writeoff deferrals 129
Panel discussion:
Concepts can be applied to any financial institution 132
Favor shorter period of time 133
Energy problem banks included under FASB-15 134
Ready to implement immediately 135
Health of the FDIC fund 138
Issuing guidelines on a broad basis 149
Intolerable delays on relief 155
In time for spring planting 158
Fed guidelines 159
Statement of the Fed, FDIC, and the OCC 152

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

American Farm Bureau Federation, statement 161
Governor Terry Branstad, Governor of Iowa, statement 164

FARM CREDIT ADMINISTRATION ACT AMENDMENTS OF 1985

THURSDAY, MARCH 6, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, D'Amato, Gorton, Mattingly, Hecht, Proxmire, Cranston, Dodd, Dixon, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Last year Congress passed legislation restructuring the Farm Credit System. During floor debate numerous proposals were offered to assist commercial banks substantially engaged in farm lending. At that time I opposed those efforts because the Banking Committee had not had the opportunity to review the suggestions and therefore the cost effects and other ramifications were unknown. However, I assured the Senate that the Banking Committee would give expeditious consideration to this very important matter.

On December 20, 1985, I wrote the bank regulators and requested the agencies to conduct an analysis of the effect the farm crisis has had on the financial institutions primarily engaged in agricultural lending. Additionally, I asked for options as to how Congress could best ease the strains resulting from such lending commitments.

Those reports were submitted to the committee in late February. Today, and at an additional hearing on March 11, we will examine the regulators' and determine what action is necessary to aid those financial institutions during this transition period.

This morning we will hear from several Members of Congress. They will be followed by Charles Sethness, Assistant Secretary of the Treasury for Domestic Finance; and the last panel will include Randall A. Killebrew and Michael E. Fitch from the ABA; B.F. "Chip" Backlund on behalf of the Independent Bankers Association of America [IBAA]; and Leslie G. Horsager will present the views of the American Council of Life Insurance [ACLI].

Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman. I commend you again for beginning this program right on time. I think we have to have a little bit more discipline on the part of the Senators who

appear. I'm glad Senator Grassley just came in and Senator Abdnor and we've got an all-star panel this morning and I'm looking forward enthusiastically to hearing them.

The CHAIRMAN. Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I just want to say that I commend you for holding this hearing. It's timely. The crisis faced by the farm credit providers is not one to be ignored. We do have an excellent group of witnesses. I hope we'll keep in mind just three things: One, that there is a need to ensure an adequate delivery of credit in the farm community; and two, we do need to provide protection to the Federal Deposit Insurance Fund. We don't want to have happen to it what could potentially happen to the FSLIC. Third and finally, I think we may have to ensure that when we consider a solution here for our agricultural banks and farmers we have to consider it in conjunction with the Nation's Federal budget deficit so that the program is realistic and cost effective.

Although only 28 percent of the banks in our country are agricultural banks, last year over 50 percent of the 118 banks that failed were agricultural banks. The FDIC has estimated that from 130 to 300 agricultural banks could fail over the next 2 years. The crisis facing our farm credit providers is not one to be ignored. I thank you, Mr. Chairman, for having these hearings so our committee can examine the crisis and the proposals that have been made to address it.

When evaluating the ideas put forth to aid our Nation's agricultural lenders, we should keep several points in mind. First, is our need to maintain an adequate credit delivery system for our agriculture sector. Residents of farm communities need and deserve deposit-taking and commercial and personal loan services. Additionally, the failure of the local bank can have a ripple effect throughout a community causing business contractions and hurting previously healthy businesses that are neither farm- nor bank-related. In western Pennsylvania we have seen that entire communities can die when the local steelmill closes. Much the same can happen when the local business is agriculture and there is no bank to lend seed money to farmers.

Second, we must protect the Federal Deposit Insurance Fund. The FSLIC's fund is potentially insolvent due to changes in the economy that hurt the thrift industry. We must not allow the same thing to happen to the FDIC's fund because of problems in agriculture. Congress must act to ensure that good banks don't close because of a temporary and correctible problem, but we must not merely delay the demise of unhealthy banks.

Third and finally, the problems facing the agricultural banks and the farmers of our country must be considered in conjunction with our Nation's Federal budget deficit. Proposals to assist the agricultural banks, the Texas banks holding energy loans, the big banks with foreign loan, must be realistic and cost effective.

I am optimistic that Congress can work within these guidelines to provide assistance to our agricultural banks and other banks suffering due to unexpected turns in the economy.

I welcome our witnesses and I look forward to hearing their proposals to address the agricultural credit crisis.

The CHAIRMAN. Senator Cranston.

Senator CRANSTON. I have no statement. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No statement.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Mr. Chairman, ordinarily I would just place my statement in the record but I have a brief statement and if the Chair would indulge me, in view of the fact that two of the bills under consideration are mine, I would like to make a statement.

The CHAIRMAN. Certainly.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning as the Banking Committee continues its hearings on problems affecting agricultural banks and our Nation's farmers. I won't take a lot of the committee's time to reiterate how serious the problem is. My colleagues appearing today and the other distinguished witnesses can do that much more eloquently than I can.

I would simply like to say that I think that we need to act now. This problem cannot wait. If the regulators could implement an appropriate package, quick legislation might not be needed. However, if the banking regulators do not act administratively, then I think this committee must act this month to report legislation to provide long-awaited and desperately needed relief for agricultural banks and their farmer-borrowers.

I am pleased that there seems to be a growing consensus that the best way to provide this relief is to enact legislation based on the concepts in the two bills I have introduced, S. 1151 and S. 1943.

These bills permit banks to amortize losses on agricultural loans over a period of years rather than having to recognize losses all at once.

Representatives of the American Bankers Association and the Independent Bankers Association of America are here to discuss their views. I would merely like to point out at this time the joint ABA-IBAA task force on agricultural credit recommended that "our first priority as a means of preserving banks' capital is to change regulatory accounting procedures and enable prudently managed banks to amortize their loan losses over a multiyear period."

Federal banking regulators are also beginning to see the merit of this idea, Mr. Chairman. They will testify next week but I think it's worth noting that the Federal Deposit Insurance Corporation in its recent paper entitled "Farm Bank Problems and Related Policy Options" stated that:

> A carefully constructed program that enabled farm banks to defer or be reimbursed for some portion of their losses could help reduce the number of farm bank failures and limit further disruption to farm communities.

The FDIC concluded that "should Congress decide to proceed with a relief program, it is the FDIC's view that the best option is a

loss deferral program." In other words, permitting banks to amortize their losses over time effectively deferring part of those losses.

This idea is not the total solution to the credit problems facing agriculture. Over the longer term we must also consider, for example, creating a secondary market for agricultural loans so that agricultural loans can be securitized like home mortgages are now. Ginnie Mae has provided major support for home finance. A secondary market for agricultural loans would help provide comparable support for farm credit needs.

Let me conclude by again stating that I do not believe there is anything we can do that would provide more help for hard-pressed agricultural banks and their farm customers than quickly enacting legislation to permit banks to amortize loan losses over a reasonable period. This idea will work. It is broadly supported in the banking and the farm communities. It is practical and it won't cost the Federal Treasury a penny. We need to move on this idea now.

I thank the Chair.

The CHAIRMAN. Thank you, Senator Dixon.

Senator Grassley, we're happy to have you before the committee today, if you would like to proceed.

Senator MATTINGLY. Mr. Chairman.

The CHAIRMAN. Excuse me. I forgot the distinguished Senator from Georgia.

Senator MATTINGLY. My chairman is up in space again.

The CHAIRMAN. Just see if I come to Georgia to help you in your reelection.

Senator MATTINGLY. You don't want me to tell about the last time you came down to help a guy? [Laughter.]

OPENING STATEMENT OF SENATOR MATTINGLY

I just want to thank you, Mr. Chairman, for initiating the reports and holding these hearings.

Along with Senator Dixon, I think we're all extremely concerned with the prospect that over 300 farm banks possibly could fail by 1988. I think that was the report that was put out by the FDIC.

I also had legislation drafted to introduce as an amendment during the consideration of the restructuring of the Farm Credit System back in December. Of course, I deferred to your request Mr. Chairman, to withhold that proposal until the Banking Committee could undertake a study of the situation.

Basically, my legislation would accomplish three things. One, it would permit the banks with large commitments to agricultural lending to write off the bad loans over 5 years. Two, it would encourage the development of a secondary market for agricultural mortgages, thus enhancing the liquidity of the farm banks. Finally, it would require an annual regulators' report to Congress on the condition and progress of these agricultural lending banks.

Now I think that we all hope that the regulators will exercise their existing authority to give some relief to the financial institutions who made commitments to our farm community. By giving temporary aid to these agricultural banks I think the benefits would flow to the farm community, thus allowing some breathing room as it passes through the adjustment period.

In closing, I'd just like to say to the administration that if the regulators don't act and if they don't act quickly, I'm certain that, led by you, Mr. Chairman, this committee is going to act very quickly. Thank you.

The CHAIRMAN. Thank you. I didn't miss you intentionally. Occasionally I used to miss John Tower because I couldn't see him. He was below eye level. [Laughter.]

Senator MATTINGLY. We sent him on to greater heights.

[The complete opening statement of Senator Mattingly, follows:]

STATEMENT OF SENATOR MATTINGLY

Mr. Chairman, I commend you for initiating the reports by the regulators and holding this hearing on the effect the farm crisis has had on financial institutions which primarily engage in argriculture lending.

I, too, am extremely concerned with the prospect that over 300 farm banks may fail by 1988, albeit the worst case scenario outlined by the FDIC. I have legislation drafted to address the situation. In fact, I had intended to introduce my measure as an amendment during consideration of the restructuring of and aid to the Farm Credit System. I, however, deferred to the request of the Chairman to withhold such proposals until the Banking Committee could undertake a study of the situation

My legislation would accomplish three things: One, it would permit banks with large commitments to agriculture lending to write-off loans over 5 years.

Two, it would encourage the development of a secondary market for agriculture mortgages, thus enhancing the liquidity of farm banks.

Finally, it would require an annual regulator's report to Congress on the condition and progress of these agriculture lending banks.

I hope the regulators will exercise their existing authority to give some relief to the financial institutions who have made a commitment to our farm community. By giving temporary aid to these agricultural banks, the benefits will flow to the farm community, thus allowing some breathing room as it passes through this adjustment period. In closing, I say to the Administration: If the regulators do not act and act quickly, Congress led by this committee will.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator D'Amato.

STATEMENT OF SENATOR ALFONSE D'AMATO

Senator D'AMATO. Mr. Chairman, I commend you for holding this important and timely hearing on the Farm Credit Administration Act Amendments of 1985. As we all remember, last December we passed landmark legislation that will infuse the Farm Credit System with Federal funds when the System reorganizes itself and exhausts its own funds. Although I voted for this legislation, I have to admit it was not my preferred option.

Unfortunately, this critical reorganization has yet to take place. The January 23 deadline, directed by the new law for the appointment of a three member board to oversee the FCA has long passed, and the longer we wait, the longer this Nation's agricultural problems will persist. New and vigorous leadership is clearly essential to effective implementation of the new law and to begin to extricate the System from its financial woes.

The Farm Credit System currently holds $66.62 billion of the Nation's $210 billion farm debt. In addition, $28 billion is held by the Farmers Home Administration. Losses by these holders may cost the Federal Government an estimated $15 billion.

I am also concerned about regulatory action the FCA is taking, despite the fact the mandated appointments have yet to be made. It is my understanding the FCA is about to issue an emergency

rule governing the organization and operation of the capital corporation, a new System entity which will acquire and manage the nonaccruing assets of the System institutions. The emergency rulemaking provisions waive the 30-day report and wait requirement of the act. I am perplexed as to why the rulemaking is an emergency, but the appointment of the Board members is not.

I hope that our distinguished witnesses will shed some light on this situation today.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Grassley.

STATEMENT OF CHARLES E. GRASSLEY, U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. I thank the committee for holding these hearings and I particularly hope that as a result of the hearings that the committee will act quickly on farm credit legislation, particularly in the area of helping troubled farm banks and their borrowers.

The first issue I'd like to make clear is that the farm crisis may appear to be localized in a few States in the Midwest, but there was an article in the New York Times earlier this week called, "The Midwest Farm Crisis Reaches East," and I'd like permission to put this article in the record at this point.

The CHAIRMAN. Without objection.

[The New York Times article follows:]

[From the New York Times, Mar. 3, 1986]

MIDWEST'S FARM CRISIS REACHES EAST

(By Thomas J. Knudson)

From the snowy pastures of upstate New York to the brown fields of New Jersey, many farmers on the edge of the metropolitan area are in trouble.

Their problems have mounted in the last year as the agricultural depression that began in the Middle West in 1981 has gathered force and brought a farm crisis to the region.

In New York and New Jersey, hundreds of farm families are being forced to leave the land. Many small towns are deteriorating as Main Street businesses and farm equipment dealerships close their doors. And some farmers have become so troubled that they have committed suicide.

"I know of five suicides in the past 8 or 9 months that were agriculturally related," said Lucinda A. Noble, director of the Cornell University Cooperative Extension system. "They were people engaged in agriculture who were overextended and decided life was not worth living."

One of the farmers who says he is being forced to quit farming is Alex Zanieski Jr., who for much of his 52 years has worked the long, loamy potato fields on the farm first settled by his grandfather near Cutchogue, on the North Fork of Long Island, and now owned by him, his brother and brother-in-law.

Burdened by about $500,000 in debt, accumulated as falling crop prices prevented them from paying off their spring planting loans, they have started to sell the 150-acre farm, and on March 21, when the farm machinery is auctioned, Mr. Zanieski's life on the land will end.

"I was hoping I could last a while longer, but I just couldn't make it," said Mr. Zanieski, a sturdy, soft-spoken man. "Hopefully I'll be able to find some kind of job. But at my age, it's kind of hard to start over."

The problems in New York and New Jersey, though serious, are not as widespread as in other, more intensively farmed regions.

Iowa, for instance, has more than four times as many farms as New York and many more troubled farmers. Also, stable land values and a more diversified farm economy have cushioned the economic blow in this region.

Mr. Zanieski, for example, has negotiated the sale of 70 acres, at $10,000 to $12,000 an acre, and the sale of the remaining acreage will eventually realize a profit for him and his partners. The farm, however, will be gone.

But even so, officials said, the problems in the two States were severe and seemed to be increasing.

"There are serious problems here," said John Brake, a professor of agricultural finance at Cornell University. "And while the numbers aren't as great as in the Midwest, and while we haven't been getting much publicity, there are a lot of farmers in the region who are not able to make it."

Farmers across the entire Northeast are in danger. "A shakeout will take place in the Northeast farming community this year," said Victor J. Riley, president of KeyCorp, an Albany-based bank holding company. "A lot of people will lose their businesses."

"We expect to see about a 10 to 15 percent reduction this year in the number of farming operations in the Northeast," Mr. Riley said. "That's a serious downturn."

A Cornell University task force projected in November that 29 percent of New York's 25,000 farmers might go out of business by 1990. "That's about 7,000 farmers," Miss Noble said. "And I think it's a conservative estimate."

HUNDREDS BEHIND ON LOANS

In New Jersey, the Farmers Home Administration said 240 farmers were delinquent on their loans, including 90 who had made no payments in 3 years. Some will face foreclosure proceedings this year, said Gerard Hlubik, the agency's chief of farm programs.

In New York, the value of delinquent farm loans jumped 20 percent last year, from $114 million in 1984 to $140 million, according to the New York Department of Agriculture and Markets.

"Nearly 20 percent of all farmers are in a danger area," said Joseph Gerace, the New York Commissioner of Agriculture and Markets. "And one in five is seriously considering getting out of business."

The farm problems have not fallen evenly across the region. "The Northeast agricultural economy is highly localized, with certain concentrated areas doing very well and others doing very poorly," Mr. Riley said.

DAIRY FARMERS IN TROUBLE

New York State is third in the Nation in milk production, behind California and Wisconsin, and third in apple growing, behind the state of Washington and Michigan.

Apple growers and nurserymen have fared well in the region, officials said, while grain, vegetable, potato, grape, and dairy farmers have been hurt badly.

The dairy industry, the region's dominant farm sector, is in especially bad shape. "This will not be a healthy year for most dairy farmers," Mr. Riley said. "Continued overproduction has depressed prices, causing significant cash-flow problems. Price supports on the Federal level are declining. I'm afraid we're going to see quite a few dairy farmers go out of business."

After setting increasingly low dairy price supports, which are paid to farmers who produce surplus milk, the Federal Government now is offering a herd buyout program, with the cost to be met by an assessment paid by other dairymen.

Potato farmers are also in "serious difficulty," Mr. Riley said. "They're being hit quite hard by domestic over-production, cheaper imports from Canada and severe price reductions. We suspect that many of the less efficient potato farmers in Maine will not survive this year."

While farm problems have dominated public debate and spurred State programs and legislation in the Midwest for years, the issue has only recently come to the forefront here.

"New York's attention to the painful effects of the current restructuring of agriculture is late in development, limited in scope and indirect in method," L. Stephen Riford, chairman of the Standing Committee on Agriculture in the New York Senate, said in a December report. He recommended that the State establish more job training and counseling services for farmers.

Some help is on the way. This month Cornell University will install a toll-free, statewide hot line, like the kind found in many Midwestern States, to provide counseling and financial advice for troubled farmers.

In New Jersey, Arthur R. Brown Jr., State Agriculture Secretary, and State Senator C. William Haines, a fruit farmer, met recently with Governor Kean to discuss a

report recommending that the State set up a $10 million fund to provide loans to hard-pressed farmers.

"Serious farm credit problems are likely to emerge because of highly variable commodity prices, relatively high interest rates, reduced exports and a heavy debt load," said the report by a State task force on agricultural financing.

SIMILAR BASIC PROBLEMS

"It makes no difference whether a farmer is here in New Jersey or in the Midwest," said Frederick Perkins, a professor of agricultural economics at Rutgers University. "The basic problems, markets and credit, are the same."

In New Jersey, grain and dairy farmers are hardest hit. "The question is not what I will do if I get out, but what I will do if I stay in," said William Pandy, a 38-year-old grain and dairy farmer in the rolling hills of the Delaware River Valley near Frenchtown. "There's no profit potential left in farming anymore."

In recent years Mr. Pandy has seen prices for his milk drop $3 a hundred weight and wheat dip $1.50 a bushel. "I figured it out, and last year I made $1.94 an hour," he said. "The farm showed a profit of about $1,500."

For years, Federal farm policies encouraged many farmers like Mr. Pandy to plant more acreage. "I feel angry and frustrated because it hasn't been that many years ago our country's leaders said 'plant from fence row to fence row and we'll take care of you, we'll see that you have markets,' " he said. "And we did it, and now they're saying, 'You fools.' "

Farmers, of course, have been leaving the land for decades. But the current shakeout is particularly serious because "the farmers in serious financial trouble are not necessarily only the small, the poorly managed, the less up-to-date," according to a report by a Cornell task force on farm economic problems.

These days those having problems include "the larger, more heavily indebted farmers who tend to be the more progressive, leading farmers," the report said.

The region's farm problems, though serious, are not as drastic as those in the Midwest, most officials said.

"Iowa is wall-to-wall farms, but New York is a more diverse State, both in terms of agriculture and its overall economic base," said Jane W. McGoingal, co-chairman of the Cornell task force report.

In the Midwest, farm land values have plunged dramatically, from $2,000 and $3,000 an acre to less than $1,000 today, seriously eroding farmers' assets and borrowing power. But land values in the Northeast, where housing and industry compete with farming for land, actually increases about 7 percent from 1984 to 1985, Mr. Riley said.

The farm problems are not confined to the farm. Small towns, too, are being hurt as farmers go out of business. "A lot of businesses on Main Street have seen a downturn in the volume and are having trouble making it," Professor Brake, of Cornell, said.

REVIEW OF THE FARM CRISIS

Senator GRASSLEY. And I would also like to draw my colleagues' attention to the fact that in July 1985 there was a Wharton Econometrics study which estimated that the eventual cumulative loss of the GNP due to the depressed farm economy will total $30 to $49 billion. So obviously, this issue ought to be important to more Senators than just those of us sitting here.

Most of the difficulties that farmers face, whether they be falling land values, high-interest rates, low-commodity prices, the loss of export markets, increased competition from imports—practically all of those things can be attributed to ill-considered Government policies.

Now I'm not going to sit here and say that all the problems we have are because of unwise political decisions, but I am going to say that a major portion of the problems we have in agriculture come from bad decisions not just in this administration but over a period of the last two or three, and not just the Congress, not just the President, but also the Federal Reserve Board.

Congress, the administration, the Federal Reserve Board have all made disastrous decisions which now endanger the livelihood of a significant percentage of the American farmers.

Over the long term the solution to the farm crisis lies in lower Federal budget deficits, lower interest rates, a lower value of the dollar, and more farm exports.

Unfortunately, these solutions don't do anything for the farmer who can't get any operating money this spring. The Wall Street Journal estimates that the Farm Credit System will not finance 100,000 borrowers this spring and that one-third of Iowa farmers still have not lined up operating loans for putting the crop in this spring.

The Senate Banking Committee, however, can do something to help that Iowa farmer get operating money this spring. Congress should instruct the Federal bank regulators to allow commercial banks to defer for up to 10 years losses which result from debt restructuring. This gives banks incentives to write down debt to manageable levels and to keep productive farmers in business.

This is a simple and it is a humanitarian solution which doesn't cost the Government one dime, but gives the farm economy some time to adjust to the new economic environment.

There isn't any reason for Congress to help banks foreclose, so I don't think that the looser regulatory treatment should apply to losses resulting from forced liquidations.

The question Senators should keep asking ourselves as we look at different proposals is, "Will this help the individual farm borrower?"

The Farm Credit System bill that we just passed in December has resulted in more foreclosures in the Omaha desert. The System now can afford to liquidate more because Federal dollars are on the way and they have no reason to compromise with the borrowers.

Now Congress should not repeat this mistake and to give commercial bankers a perverse incentive to foreclose as well.

The large multinational banks have been given time to restructure their troubled international loans. The savings and loans have been allowed to operate with negative net worth. Continental Bank and Chrysler have stayed in business with Government help. I don't see how anyone could argue with a straight face that we should not help the farm economy because it would distort some mythical free market.

There are other steps beyond the jurisdiction of this committee which Congress should also take to head off the credit squeeze this spring and I will just quickly refer to them: Senator Boschwitz' bill No. 1; No. 2, we should change the way the Farm Home Administration guarantees are treated for budgetary purposes. Currently the entire value of the guaranteed loan is counted against the guarantee budget even though the highest amount that can be guaranteed is 90 percent of the loan value and the Government historically has paid only 5 to 10 percent of the guarantees. A change in this accounting procedure would free up much more Farm Home Administration guarantee authority. We should approve Senator Nickles' legislation which stops the Farm Credit System's unnecessary foreclosures. Also, the farm bill authorized $490 million of

Farmers Home Administration interest rate buydown money over the next 3 years and we should push more of that money, but just up to that amount of money, forward so that it can be used for restructuring this year.

I want to thank the chairman for holding these hearings and allowing me to testify and I look forward to working with my colleagues to pass legislation dealing with these issues. Thank you.

The CHAIRMAN. Thank you, Chuck.

Senator Abdnor.

STATEMENT OF JAMES ABDNOR, U.S. SENATOR FROM THE STATE OF SOUTH DAKOTA

Senator ABDNOR. Mr. Chairman, Senator Proxmire, members of the Banking Committee, I thank you for holding this committee meeting on a particular subject that's so important to the Midwest particularly but, as Senator Grassley pointed out, is spreading across the whole country—the farm problem.

I've often wondered what it was like to serve on this distinguished committee, but after hearing the bantering and exchange that goes on between you I don't think I'd want to try to keep up with the quick wits that seem to be here. I just want you to turn those wits to the problem at hand and I'm sure we could do well in solving the problem that I have such a great interest in.

And I want to thank the chairman—I've bugged him on several occasions and he's even been kind enough to come to the office and sit down with some of us so we could discuss the agricultural problem which I know interests this entire committee. It couldn't be otherwise, because all of you come from States that have some agriculture and it's catching up with the whole country.

As I know that my fellow farm State Senators on this panel can attest to, the high volume of farm debt included in the asset structure of the majority of rural banks that has become exceedingly burdensome to the lenders. For many banks in my State diversification is not an option. The asset base which generates South Dakota's GNP is highly concentrated. Without a diversified asset base, and in many cases without access to capital markets, farm banks in South Dakota have no alternative but to grit their teeth and hope the next year is going to be better.

Mr. Chairman, I don't need to dwell on the endless number of statistics which have been generated to shed light—or perhaps darkness is more appropriate—on the problem faced by agriculture. You and I are both aware of the fundamental reasons for the current credit crisis. I know as well as anybody that agriculture has been dealt a bad hand, but quite frankly, I'm sick and tired of hearing about the problem. I'm just about fed up with the doom and gloom scenarios being painted by those who have nothing more constructive to do than to criticize.

HIGH TIME TO FOCUS ON SOLUTIONS

Mr. Chairman, it's high time we begin to focus on solutions to the problem of agriculture and the credit crunch it has created. I know you have a number of options under consideration for dealing with the credit crisis and all I ask is that when you and your

colleagues begin to determine the proper course of action you give careful attention to treating not only the symptoms of the problem but the roots as well. By that, I mean I hope you will focus your efforts on assisting the key player in the game and that's the borrower.

The viability of any lending institution is based on the ability of its borrowers to service their debts, not on the institution's ability to dispose of assets after foreclosure. The stabilization of agricultural borrowers' debts and their ability to cash-flow that debt is crucial to the success of any solution. For that reason, I believe any serious solution must be borrower-oriented and not simply bank-oriented.

In my opinion, some sort of restructuring of current borrower debt is an absolute must.

I've strongly supported my distinguished colleague and good friend from Minnesota, Rudy Boschwitz, who has been highly instrumental in developing a borrower-oriented package which calls for a restructuring of farm debt.

This bill, the Farm Credit Partnership Act, proposes several provisions designed to restructure existing debt. This bill consists of a 5-percent interest rate buydown, a principal forgiveness provision, and a stretched out amortization period allowing banks to write off the forgiven principal over a 10-year period of time, this is the same legislation that Senator Grassley was mentioning a few moments ago.

In addition, I believe the Farmers Home Guarantee Program can be utilized to a much greater extent than it currently is. Expansion of the guarantee program would be a very cost-efficient means of stabilizing and restructuring agricultural debt.

Further, change in the accounting treatment of FmHA guarantees to reflect their true budget impact would be of great assistance in making more guarantee capital available. As I understand it, guarantees are scored dollar-for-dollar in the budget when they are actually a contingent liability and not a direct outlay.

In summary, Mr. Chairman, I fully support your efforts to address this problem and hope that your committee, in conjunction with the banking regulators, will direct your efforts not only toward policies that will stabilize bank capital but also toward policies which will get to the guts of the credit crunch—the borrowers who need to cash-flow on their debt.

The need for action is clearer now than ever before and nowhere more evident than in the agricultural sector. Farm banks have accounted for over 50 percent of the bank failures in the last 14 months, a glaring example of the need for Congress, the regulators, and the lenders and borrowers alike to work together to secure a stable future for both lenders and borrowers of agricultural credit.

Thank you.

The CHAIRMAN. Thank you, Jim.

Congressman Bruce, we're happy to have you before the committee today.

Senator DIXON. Mr. Chairman, would the Chair indulge me?

The CHAIRMAN. What would you like to be indulged in?

Senator DIXON. The witness is an old friend. I'd like to present him to the committee, Mr. Chairman.

The witness is Congressman Terry Bruce from my State who is an old friend who served with great distinction in the Illinois State Senate for a great many years as the majority leader of the Illinois State Senate. He is completing his first term in the Congress and will be here a long time.

He represents the district encompassing the University of Illinois and some of the finest and most fertile farm land in the world in Champaign County, and I'm delighted to introduce to this committee a very fine Congressman, Congressman Terry Bruce, from my State of Illinois. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Please go ahead.

STATEMENT OF TERRY L. BRUCE, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Representative BRUCE. I almost wanted to wait for applause from the audience after an introduction like that. I appreciate Senator Dixon's introduction.

I appreciate the opportunity to testify before your committee. I have introduced in the House H.R. 4241, which is a House companion bill to Senator Dixon's bill, S. 1943, and I'd like to associate myself with the remarks that he made earlier today and also to thank him for the assistance he's given to me. I share his belief that we've got to act very quickly in this matter to assist farm bankers and borrowers.

The farm economy in Illinois is certainly in a very critical state. Nationwide, last year we lost over 40,000 farmers and the Illinois Crop Reporting Service believes that we could lose 4,000 to 5,000 farmers in Illinois this year alone. A record number of banks are on the watch list and the FDIC has stated that as many as 150 agricultural banks could fail this year, up from 62 last year.

That has a ripple effect in my district, which contains very many small communities. Now, 15 of the 18 counties in my district face double-digit unemployment. I think we've got to act now before the situation worsens. A bank failure in my area in one of the small towns increases the risk of foreclosure not only for area farmers but also for the small businessmen who already are having a very tough time paying off their loans. Stopping the financial erosion in small communities is as vital as stopping soil erosion on our farms.

AMORTIZE LOAN PAYMENTS OVER 10-YEAR PERIOD

The legislation we have introduced allows farm banks to amortize loan payments for a period of 10 years. It will give bankers and farmers breathing room, and they have to have that breathing room to cope with the very tight agricultural situation they face. Farmers do not leave farming, nor do banks foreclose, in my area, unless they have exhausted every other option. The banks don't want to put farmers out of business. But although the farm banks have been strongly and solidly capitalized, so much of their portfolios now are tied into farming that with the farming situation is down they've been very vulnerable to the fluctuations in the farm economy.

They have been caught with a unique combination of bad news in Illinois. A dramatic drop in farm land values reduced the collateral value of most of their loans. High-interest rates and low-crop prices, on the other end of the spectrum, have eroded the farmers' ability to pay off those notes.

Nonperforming loans reported at agricultural banks are trending upward and all signs indicate that rural lenders and their customers will face even more severe difficulties this year than last.

We've had some hints of an improvement in the situation. The University of Illinois has reported that farm land values have bottomed out and begun to stabilize. In fact, they are up about three-tenths of 1 percent in Illinois. But farm exports, interest rates, and farm profitability won't turn around overnight. And farmers are going to need capital in Illinois in the next couple of months to get the crops in the ground. So we have to make credit decisions right now for Illinois farmers.

The legislation before you is simple and straightforward. It will facilitate banks cleaning up their portfolios by going ahead and charging off loans when that is warranted. Under current law, if they charged them off, the banks would face a large reduction in bank capital. This would substantially weaken their ability to sustain even their good borrowers. I want to emphasize that, that an immediate chargeoff of the loans that they have in the agricultural area will force most banks in my area to stop loaning even to the best borrowers they have. By allowing banks to take losses over 10 years, we can improve their chance for survival and their ability to work with troubled borrowers.

A second part of the bill which allows agricultural banks to amortize losses on farm land would help stabilize land values and help banks manage the devalued land they now hold as bankers.

I don't want to go into the details of the legislation, but I would just note that there's a groundswell of support for a loan loss deferral. The Independent Bankers, the American Bankers, and the Farm Bureau all support this proposal. The FDIC has indicated their willingness to give it serious consideration.

This bill won't solve the farm crisis, but it's a transitional measure that will give assistance to keep rural credit available, keep farmers farming, and give small community—again emphasizing small communities—that depend on agricultural banks some stability.

Farm credit is already tight in Illinois. Farmers Home Administration office located in Champaign, IL, have already indicated that they've got more credit requests than they can handle. I think we need to take full advantage of the 1985 farm bill which gives them an interest rate reduction buydown, but commercial banks in my area don't have the FmHA backing of the Farmers Home Program, nor do they have the flexibility given to the Farm Credit System last fall. So they still find it very hard to make ends meet and serve farmers this year. Given the tight Federal budget situation, the ability to amortize agricultural loan losses will be particularly important to help the bank make lending decisions next year.

This legislation offers temporary relief for farm banks. It is a regulatory adjustment which offers agricultural lenders a chance for self-help, and it costs nothing. I believe this legislation could

represent an important component in our efforts here and in the House to keep our agricultural banks and their customers in business.

I appreciate the committee giving me the time to testify this morning.

[The complete prepared statement follows:]

STATEMENT OF TERRY L. BRUCE, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS

Mr. Chairman, I appreciate having the opportunity to testify today on agricultural banking issues. I have introduced H.R. 4241, the House companion bill to Senator Dixon's bill S. 1943. I would like to start by associating myself with the remarks of my colleague from Illinois and to thank him for his assistance. I share his belief that we need to act quickly to assist our farm bankers and borrowers.

The farm economy is in a critical state. Last year over 40,000 farmers went out of business, and the Illinois Crop Reporting Service believes we could lose 4,000 to 5,000 farmers this year in Illinois alone. A record number of banks are on the Federal regulators' problem list, and the FDIC has stated that as many as 150 agricultural banks could fail this year—up from 62, last year's record high.

Many rural areas are feeling the ripple effect of agriculture's hard times. Fifteen of the counties in my district face double-digit unemployment. It is imperative that we act now, before the situation worsens. A bank failure in one of the small towns in my district would greatly increase the risk of foreclosure for those area farmers and small businesses already having a hard time paying off their loans. Stopping the financial erosion on our farms is as vital as stopping soil erosion.

The legislation we have introduced, allowing farm banks to amortize loan losses over a period of 10 years, is a measure to give banks and farmers some breathing room to cope with the tight agricultural situation. Farmers do not leave farming, nor do banks foreclose, unless they have exhausted all other options. Agricultural banks have always been strong and solidly capitalized, but because so much of their portfolios are tied in with farming, they are particularly vulnerable to the fluctuations of the agricultural economy.

The problems of the farm sector are due to a unique combination of financial pressures. A dramatic drop in farm land values reduced the collateral value of many loans, while high-interest rates and low-crop prices have eroded farmers' ability to keep up with their payments. Nonperforming loans reported at agricultural banks are still trending upward, and all signs indicate that rural lenders and their customers will face continued difficulties this year.

We have the first hint of an improvement in the agricultural picture with the news that farm land values may have bottomed out and begun to stabilize. But farm exports, interest rates, and farm profitability won't turn around overnight—and farmers need capital to get their crops in the ground over the next few months. Credit decisions must be made now.

Our legislation is simple and straightforward. The amortization option will facilitate banks cleaning up their portfolios by going ahead and charging off loans when that is warranted. Under current law, which requires that loan losses be taken in 1 year, agricultural banks could face a large reduction in their bank capital. This would substantially weaken their ability to sustain even their good borrowers. By allowing banks to take losses over 10 years, we can improve their chance for survival and their ability to work with troubled borrowers. The second part of the bill, which allows agricultural banks to amortize losses on farmland they have acquired, should help stabilize land values and help banks manage the devalued land they now hold.

I won't take the time to go into the details of this legislation right now. What's important is that there is a groundswell of support for a loan loss deferral program. The Independent Bankers, the American Bankers, and the Farm Bureau support this proposal, and even the FDIC has now indicated its willingness to give it serious consideration. This bill won't solve the farm crisis, but it will provide needed transitional assistance to keep rural credit available, keep farmers farming, and give the small communities that depend on agricultural banks some stability.

Farm credit is going to get very tight very soon. Already FmHA officials in many States, including Illinois, have more credit requests than they can handle. I believe that we must take full advantage of the credit provisions of the 1985 farm bill, including the new interest rate reduction program. But commercial banks, which have neither the FmHA's Government backing, nor the new flexibility we made available

to the Farm Credit System last fall, will still find it hard to make ends meet and service their farmers this year. Given the tight Federal budget situation, the ability to amortize agricultural loan losses will be particularly important to banks making lending decisions this spring.

Our legislation provides temporary relief for farm banks. It is a regulatory adjustment which offers agricultural lenders a chance for self-help. It costs nothing. I believe this legislation represents an important component of efforts to keep our agricultural banks and their customers in business. I appreciate the committee's giving this issue high priority. Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you very much, Congressman.
Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you, Mr. Chairman.

First, I want to congratulate the three witnesses who have testified this morning. I think they have done an excellent job. I think they are absolutely right. Too few people, unfortunately, in the Congress and in the country really understand and appreciate the terrific problem that farmers have.

The long hours they work—the University of Wisconsin has found in our State the typical farmer works 10 to 12 hours a day, 52 weeks a year, 7 days a week. They are enormously efficient and productive, the most efficient group in our society. Last year we had a drop in productivity overall for this country, but farm productivity increased 11 percent. So they are productive, they work hard, they make a big investment. They do everything people are supposed to do in a free enterprise system to make money and they're losing their shirt.

So I think your testimony is very, very helpful, particularly in view of the fact that I now find—I don't know if you saw that article in the New York Times just last week I think it was—that for the first time, more than half the people in the country believe that we should help the farmers. That's unusual because we have a very small percentage of people who are actually on farms now, about 3 percent. More than half the people now say we should help the farmers because they know they have worked very hard, they deserve it, and that the country's future depends on a strong agriculture.

I would like to also say that the bill offered by my two friends from Illinois, Congressman Bruce and Senator Dixon, makes a lot of sense. I'd like to ask you about that, Mr. Bruce.

I understand that what the bill provides, on page 2—I'll just read part of the first sentence:

> Any loss in any qualified agricultural loan that an agricultural bank would otherwise be required to show on its annual financial statement for any year between December 31, 1984 and January 1, 1990 may be amortized on its financial statement over a period not to exceed 10 years.

Now I understand that the administration already has a Loan Loss Deferral Program for big banks in trouble from their foreign loans and that permits these loans to stay on the books not for 10 years but forever.

You're asking for a more modest consideration for our farmers, American citizens who pay taxes, than for foreign loans. It seems to me that makes an awful lot of sense and, as you say, it's not

going to cost anything unless we have a complete collapse of the agricultural system.

Let me just defer asking questions and tell you that I think you did a great job. Thank you very much.

The CHAIRMAN. Senator Mattingly.

10-YEAR PROVISION

Senator MATTINGLY. I would just like to ask any of the three witnesses, with reference to the loan loss deferral, I know that Senator Dixon's bill has a 10-year provision in it, but have you given any thought to a lesser number of years, something like 5 years?

Senator ABDNOR. I think it's interesting that all three of us proposed 10 years, not knowing what each other was doing here. Obviously, that seems to be the thought, but I'm sure banks would appreciate any kind of adjustment in that.

Representative BRUCE. Regarding the 10-year period, as we saw it in Illinois, this is a transitional bill and I would perceive the usage of the legislation would occur within the next 5 years. We hope that by that time the farm economy is restabilized and land values and prices are both up. The 5-year window of opportunity would stretch the amortization over 10 years, but I think there are some accounting procedures that should make us wary of going beyond 10. And 10 seems to be the figure.

Senator MATTINGLY. I wasn't recommending going beyond 10. I was recommending the possibility of looking at a lesser number of years.

Representative BRUCE. Well, frankly, the problem with, for example, cutting that in half is that I don't think for many farmers and banks a 20-percent writeoff per year would be very much assistance. When it's a matter of going into the banking end of it to write off a bad note that's running over $500,000 or something, to some of these banks 20 percent would still be a difficulty. We thought 10 years gives a chance for the bank to work it out and also for the area farmer to understand that when they borrow the money 10 years is the maximum payback.

Senator MATTINGLY. I was just looking at the possibility that there will be some interim—it probably won't be 10 years, I would guess, being pragmatic as we are.

That's all the questions I have, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. I will defer my question opportunity, Mr. Chairman. There are other witnesses here, including a distinguished Illinoisan, the president of the Independent Bankers Associations, so I think I'll wait and question him later.

I want to thank these witnesses for their fine presentations, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. I agree with Senator Dixon. I do find it remarkable how similar the testimony of these witnesses has been, apparently without checking with one another.

I appreciate the advice of both of my two distinguished colleagues here and my friend, the Congressman from Illinois.

The CHAIRMAN. Senator D'Amato.

Senator GRASSLEY. Mr. Chairman, could I say one more thing? I had the opportunity to testify before Senator Gorton's committee last summer dealing with the regulatory practices of the Comptroller of the Currency and the other regulatory bodies.

I've had an opportunity to meet with a lot of those people in my office in the months since then, and we're always led to believe that there are changes being made, but I haven't seen see any differences in the process of examining to accommodate these problems we have at the grassroots. What's coming out at the other end is very different from what we're told here.

In other words, the examiners are going into individual banks and there's the same lack of sensitivity toward the problem, lack of understanding the problem, and none of the things that we're told that would be done to accommodate the situation—none of them as extreme as this legislation we're talking about obviously—are being carried out.

So, if people here in Washington sincerely want things to be changed, then I would hope this committee would use its power and prestige and oversight function to see that those changes are being carried out at the grassroots.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

I am intrigued by the loan loss deferral legislation that my distinguished colleague, Senator Dixon, and my other colleagues have put forth, and I'd just like to ask one question because I am inclined to be supportive of this legislation—whether or not the period of December 1984 and the date 1990—I think you need the 10 years by the way—that's absolutely, because otherwise you're not giving—as the Congressman testified, 20 percent writeoff, you're not helping.

But one of the areas you might get in trouble or I could see some trouble is saying, "Well, look, you're going to say this is a policy for loans that are going to be made out to 1990," is that sacrosanct with you or could you see bringing that 1990 date back?

I think it's important to say that the people are in trouble now and on those to give them some relief because you have a well-established pattern already on the books. So if you could shrink that 1990 date back, what would your feeling be on that?

Senator DIXON. Well, I think I would be open to any suggestions, may I say to my distinguished friend from New York State, and there are some excellent witnesses that will follow our colleagues here that will discuss the technical aspects of this both as to the period of amortization—because as you know I have a 30-year bill and a 10-year bill before the committee—both as to those propositions and the other dates in the bill, I would be open to the suggestions of this distinguished committee as the hearing unfolds.

Senator D'AMATO. Once again, I want to commend the witnesses and thank my colleague.

Senator DIXON. I thank my friend from New York State.

Senator ABDNOR. I certainly want to thank you all for allowing us this opportunity to express our thoughts on this problem.

The CHAIRMAN. We appreciate your testimony. Thank you very much.

Next I'd like to call to the witness table Charles O. Sethness, Assistant Secretary for Domestic Finance, Department of the Treasury.

Mr. Sethness, if you would hold for just a moment, we have the honor of having the distinguished majority leader here and we would like to hear from him.

STATEMENT OF ROBERT DOLE, U.S. SENATOR, FROM THE STATE OF KANSAS

Senator DOLE. Mr. Chairman, I appreciate very much just to come by and I don't know what the previous members have said but to indicate the severity of the problem and also to indicate to committee members that if we can report something out of this committee I will do my best to get it up, if not this month, at the earliest possible time, because there is a problem and I think you have the expertise.

OPPOSED TO BUYDOWN PROGRAM

I'm not one of those that says we ought to have a big interest buydown program and get into a lot of additional costs. I don't really believe that would finally address the problem.

I know some of my colleagues feel very strongly there should be some combination of Federal buydown and State buydown and then the bank would take another cut.

But I wanted to stress primarily that we are prepared to bring up a bill if we could get one out of this committee, hopefully with bipartisan support, and some agreement on the floor that we're not going to try to Christmas tree it. I know the Chairman feels very strongly about bringing out a bill after a lot of hard work and everybody tries the old game of oneupmanship—who can do the most.

But on this committee, I think if you had a strong effort with Democrats and Republicans, you would have fair success as you know on holding the line on the Senate floor and that would encourage me to bring the bill up rather quickly.

I would only make one or two suggestions and I apologize for being in the way here, but I think one concern that we have in the farm area—and I don't disagree with any of my colleagues and I can almost imagine what they may have said—we did address the Farm Credit System and it's pretty hard for our farmers to understand and many small bankers to understand how we keep talking about renegotiating all the foreign debts and we're not really focusing on a number of small commercial banks that are in real trouble. In parts of my State where there are not many people, when the bank is in trouble, when the bank closes up, the community closes up. So we would like to keep people out in the small towns in Kansas and throughout America.

You all know the statistics. We had 120 bank failures last year and 13 of those were in Kansas. There are many more Kansas and other banks on the trouble list. I guess you could blame the lenders and say they should have been more prudent loans, they were too optimistic on commodity prices.

We've got sort of a double problem in parts of America. In addition to bad troubled farm loans, we've got some energy loans that

are in deep, deep trouble because the price of oil has dropped, which is good news for a lot of people, but if you are a bank and you've got a big energy loan and they're not drilling for any oil and the price has dropped down to $12 and $13 a barrel, we've got a double problem in some places.

I want to commend many members of the administration. They have been very helpful in my State in visiting with rural bankers, farmers, and others in an effort to figure out a good program.

What we do not want is something that may be perceived as a bill to bail out the bankers. That would not be good news to the Kansas farmers and others and that's not the purpose of anything I know this committee would do, but as I have indicated, when a bank dries up, the community dries up.

I think you've had some testimony on permitting a bank to amortize its loan losses over a 5-year period. I don't know how the technical aspects can be worked out, but it seems to me it does provide a bank some breathing room until economic conditions improve and I think this is something that shouldn't be an open-ended program. It should be limited to those banks that need to avoid falling below capital requirements and, in my view, should be limited to those banks who are in trouble due to an excessive concentration of either agricultural or energy loans. I know there are experts who can testify to that.

I think a bank should submit a plan to the appropriate regulatory agency outlining how the Amortization Program would work, and steps the bank intends to take to avoid further deterioriation in its financial conditions. And if it's the regulator's opinion the bank will probably fail even if allowed to defer loan losses, there's really no reason to allow a bank to utilize this loan loss deferral approach.

EXPANDED FDIC AUTHORITY

I think we could also suggest expanded FDIC authority to prevent bank closing and I have visited on this with Bill Seidman about this particular aspect. At present, the FDIC must simply wait for the bank to close before they can act, and I advocate giving him the authority to act prior to closing. Hopefully, they can develop a system of locating potential bidders before the doors of the bank are closed and depositors are frightened.

In some cases, it may be more cost efficient for the FDIC to actually pay a bank to take over a loan portfolio rather than manage the portfolio itself.

I also believe that if we're serious about keeping the community bank open we must examine the restrictions presently placed on potential buyers of the bank. In some cases where branching is not allowed, the branching requirements serve to effectively close the community bank. And while I know many bankers in my State will disagree with me, for reasons that I do not totally understand, we must consider allowing an expanded number of institutions to acquire failed and failing banks, if the alternative is the evaporation of banking services in a given community.

Banks and thrifts, both within and outside a State, should be given the right to provide financial services before the bank is permanently closed.

This is an emotional issue among many bankers, but again, I've seen entire towns dry up when the bank closes and I'm more concerned about maintaining banks in the communities than bankers.

I've just touched on a couple of areas. I know that the committee here will do the right thing. I'm not certain just what that is. I don't know if anybody knows at this point. But again, I would indicate to the chairman and members on both sides, that if you get something ready, we will get it up on the Senate floor.

[The complete prepared statement follows:]

STATEMENT OF SEN. BOB DOLE

RELIEF FOR TROUBLED COMMERCIAL BANKS

PRESENTED TO

U.S. SENATE COMMITTEE ON BANKING, HOUSING AND

URBAN DEVELOPMENT

MARCH 6, 1986

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I'M HERE TODAY AS A SENATOR FROM KANSAS CONCERNED ABOUT THE CONDITION OF THE BANKING INDUSTRY IN MY STATE AND REGION. THE MATTERS WE ARE DISCUSSING TODAY ARE OF THE HIGHEST PRIORITY. I WOULD SUGGEST THAT WE MUST DECIDE RIGHT AWAY WHETHER WE WANT TO WORK TOGETHER TO CRAFT POSITIVE SOLUTIONS TO THE PROBLEMS, OR WHETHER WE JUST WANT TO DEMAGOGUE THE ISSUE. I SUGGEST WE WORK QUICKLY TO PROVIDE SOME RELIEF WHERE IT IS NEEDED.

I WOULD REITERATE TO THE CHAIRMAN AND ALL MEMBERS OF THE COMMITTEE THAT I WILL DO EVERYTHING POSSIBLE TO SCHEDULE TIME ON THE SENATE CALENDAR - PERHAPS YET THIS MONTH - FOR LEGISLATION PROVIDING RELIEF TO COMMERCIAL BANKS WHICH THE COMMITTEE MAY REPORT OUT. BUT I WOULD STRESS MY HOPE THAT WE CAN APPROACH THIS IN A SPIRIT OF BI-PARTISANSHIP. BECAUSE THE SENATE SCHEDULE FOR THE NEXT SEVERAL MONTHS IS ALREADY EXTREMELY CROWDED, MATTERS WHICH REPRESENT THE PROMISE OF PROTRACTED DEBATE MUST NECESSARILY FALL IN LINE BEHIND THOSE ALREADY ON THE SENATE CALENDAR. SO AGAIN, I HOPE WE CAN WORK TOGETHER TO FIND SOLUTIONS WHICH ARE HELPFUL AND WHICH HAVE A REAL CHANCE OF BEING IMPLEMENTED.

SOME FELT WE SHOULD HAVE ADDRESSED THE ISSUE OF RELIEF FOR COMMERCIAL BANKS DURING CONSIDERATION OF FARM CREDIT LEGISLATION IN DECEMBER. INDEED, THERE MAY A STRONGER CASE FOR PROVIDING RELIEF TO BANKERS WHO HAVE PUT THEIR OWN CAPITAL AT RISK THAN TO THE FARM CREDIT SYSTEM. IN ANY EVENT, WE DID ADDRESS THE FARM

CREDIT SYSTEM REFORMS, AND IT IS INCUMBENT UPON US NOW TO LIKEWISE ADDRESS THE COMMERCIAL BANK SIDE OF THE EQUATION. I ANTICIPATE A SCENARIO UNFOLDING LATER THIS YEAR INVOLVING DEBT RESTRUCTURING TO OUR ENERGY PRODUCING LATIN AMERICAN FRIENDS. AND I MUST SAY THAT I WILL HAVE A HARD TIME EXPLAINING TO THE CITIZENS OF MY STATE WHY WE KEEP RENEGOTIATING FOREIGN DEBT WHEN WE CAN'T SIMILARLY PROVIDE RELIEF TO OUR DOMESTIC BANKING INDUSTRY. SO I HOPE WE KEEP OUR PRIORITIES IN ORDER.

THERE WERE APPROXIMATELY 120 BANK FAILURES IN THE U.S. LAST YEAR. THIRTEEN OF THOSE WERE IN KANSAS. AT THE END OF 1985, THERE WERE SEVERAL HUNDRED MORE BANKS ON THE PROBLEM LIST. WHEN WE STARTED THE YEAR, WE KNEW THAT WE WERE ALMOST CERTAIN TO HAVE A NUMBER OF ADDITIONAL BANK FAILURES IN 1986 - PRIMARILY AG BANKS. BUT WE ALL KNOW WHAT HAS HAPPENED TO OIL PRICES SINCE JANUARY AND THE EFFECT THAT WILL HAVE ON BANKS WHO HAVE BEEN LENDERS TO THAT INDUSTRY. AND OF COURSE PROBLEMS IN THAT SECTOR HAVE LED TO OTHERS, SO WE KNOW THAT ANY BANK WITH A HIGH CONCENTRATION OF FOREIGN OR REAL ESTATE LOANS WILL REQUIRE CLOSE SCRUTINY THROUGHOUT THE YEAR. CONTRARY TO THE BELIEFS OF SOME, COMMERCIAL BANKING PROBLEMS ARE NOT ISOLATED TO SMALL GEOGRAPHICAL AREAS OR TO ANY ONE INDUSTRY.

IN SOME CASES, LENDERS MAY HAVE MADE OVERLY OPTIMISTIC ASSUMPTIONS ABOUT COMMODITY PRICES. SOME WOULD ARGUE THEY ARE NOW GETTING WHAT THEY DESERVED. IN OTHER CASES, THE SAME CAN'T BE SAID. I WOULD LIKE TO BE ABLE TO TELL YOU, MR. CHAIRMAN, THAT I KNOW HOW TO DRAW THE LINE SO THAT WE CAN ONLY PROVIDE AID TO THOSE BANKS WHICH WERE GENERALLY WELL MANAGED BUT VICTIMIZED BY UNFORESEEABLE DEVELOPMENTS IN THE WORLD MARKETPLACE. I WOULD LIKE TO BE ABLE TO DRAW SUCH A LINE, BUT I CAN'T. ALL I KNOW IS THAT WE CAN'T SAVE EVERY LOAN OR EVERY BANK. TO DO SO WOULD REQUIRE THAT WE BAIL OUT EVERY INDUSTRY WHICH IS CURRENTLY EXPERIENCING DIFFICULTIES. WE DON'T HAVE THAT RESPONSIBILITY; NOR WE DO HAVE THE RESOURCES. BUT WHAT WE CAN DO IS PROVIDE SOME LIMITED AID WHICH WILL HAVE A STABILIZING EFFECT ON THE FINANCIAL INDUSTRY AS A WHOLE.

I HAVE VISITED WITH A NUMBER OF EXPERTS KNOWLEDGEABLE IN THIS FIELD OVER THE PAST SEVERAL MONTHS. WE HAVE DISCUSSED A WIDE VARIETY OF OPTIONS, FROM GREATER FORBEARANCE ON ONE END OF THE SPECTRUM TO INTEREST RATE AND PRINCIPAL BUY-DOWN SCHEMES ON THE OTHER. MANY OF THESE PROPOSALS TO AID COMMERCIAL BANKS ARE OFTEN REFERRED TO AS SIMPLY SCHEMES TO "BAIL OUT THE BANKERS". AND I AGREE: WE MUST AVOID SIMPLY BAILING OUT THE BANKERS.

AT THE SAME TIME IT MUST BE RECOGNIZED THAT IN MANY CASES, WHEN THE LOCAL BANK CLOSES, THE COMMUNITY DRIES UP. IT IS AS SIMPLE AS THAT. THERE ARE EXAMPLES ALL THROUGHOUT THE FARM BELT. THERE MAY SOON BE EXAMPLES THROUGHOUT THE ENERGY PRODUCING SOUTHWEST. IN MY VIEW, WE NEED TO SEARCH FOR RESPONSIBLE WAYS TO AID COMMERCIAL BANKS WHERE IN DOING SO, WE ARE KEEPING ALIVE ENTIRE COMMUNITIES - ENTIRE COMMUNITIES WHICH ARE COMPRISED OF FARMERS, ENERGY PRODUCERS AND OTHER SMALL BUSINESSMEN AND WOMEN WHOSE ACCESS TO COMMERCIAL CREDIT WOULD BE SERIOUSLY JEOPARDIZED BY THE ABSENCE OF A COMMUNITY BANK.

STABILIZING BANK CAPITAL

REPRESENTATIVES OF THE THREE FEDERAL BANK REGULATORY AGENCIES (FDIC, COMPTROLLER OF THE CURRENCY, AND THE FEDERAL RESERVE) HAVE ALL ADOPTED CAPITAL STANDARDS WHICH ESSENTIALLY PROVIDE THAT BANKS SHOULD MAINTAIN A CAPITAL RATIO OF AT LEAST 6 PERCENT. A DECLINE IN THIS RATIO HAS OCCURED AT MANY BANKS AS MANAGEMENT HAS BEEN FORCED TO TAP CAPITAL IN ORDER TO ABSORB LARGER THAN ANTICIPATED LOAN LOSSES.

WHILE I WILL NOT QUARREL WITH THE CAPITAL TO ASSET RATIO THAT MUST BE MAINTAINED, I FEEL IT IS IMPERATIVE TO REMEMBER THAT A BANK'S CAPITAL IS ESSENTIALLY A CUSHION AGAINST HIGHER THAN ANTICIPATED LOSSES. MEMBERS OF THIS COMMITTEE MAY HEAR A LOT ABOUT HOW IRRESPONSIBLE IT IS TO LOWER CAPITAL REQUIREMENTS, OR TO DEFER LOAN LOSSES SO THAT ADDITIONAL CAPITAL IS NOT IMPAIRED. BUT IF WE ASSUME THAT THE UNDERLYING ECONOMIC CONDITIONS WHICH HAVE ADVERSELY AFFECTED AGRICULTURAL AND ENERGY BANKS WILL STABILIZE AND IMPROVE IN THE NEXT FEW YEARS, OFFERING SOME TEMPORARY MEASURES TO STABILIZE BANK CAPITAL - EITHER THROUGH RELAXATION OF CAPITAL REQUIREMENTS OR MORE FORGIVING ACCOUNTING PRACTICES AFFECTING CAPITAL ACCOUNTS - MAKES GOOD SENSE. AND IT IS CONSISTENT WITH WHAT I PERCEIVE TO BE THE PURPOSE OF BANK CAPITAL REQUIREMENTS.

IN MY VIEW, THERE IS MUCH TO BE SAID IN THE CURRENT ECONOMIC CLIMATE FOR ALLOWING A BANK TO AMORTIZE ITS LOAN LOSSES OVER A 5 YEAR PERIOD. THE EXPERTS CAN ARGUE ABOUT THE TECHNICAL ASPECTS, BUT IT SEEMS TO ME IT SIMPLY PROVIDES A BANK SOME BREATHING ROOM UNTIL ECONOMIC CONDITIONS IMPROVE. LENDERS AND BORROWERS WOULD HAVE THE OPPORTUNITY TO ADJUST TO A CHANGED ECONOMIC ENVIRONMENT, WHETHER IN THE AGRICULTURE OR ENERGY SECTOR. AND, IMPORTANTLY, LENDERS WOULD BE MORE INCLINED TO RESTRUCTURE PROBLEM LOANS AS THEY WOULD NOT HAVE TO IMMEDIATELY ABSORB THE LOSSES ASSOCIATED WITH SUCH ACTIONS. THIS WOULD PROVIDE MUCH NEEDED RELIEF TO BORROWERS, AND WOULD SERVE TO INCREASE THE DOLLARS AVAILABLE FOR LOANS.

WHILE I FAVOR AN AMORTIZATION OF LOAN LOSS PROGRAM, I DON'T FEEL IT SHOULD BE AN OPEN ENDED PROGRAM. IT SHOULD BE LIMITED TO THOSE BANKS THAT NEED IT TO AVOID FALLING BELOW CAPITAL REQUIREMENTS. AND IN MY VIEW, IT SHOULD BE LIMITED TO THOSE BANKS WHO ARE IN TROUBLE DUE TO AN EXCESSIVE CONCENTRATION OF EITHER AGRICULTURE OR ENERGY LOANS. ONE FORMULA TO BE CONSIDERED IS TO ALLOW AMORTIZATION OF LOAN LOSS TREATMENT TO BANKS WHERE COMBINED AGRICULTURAL OR ENERGY RELATED LOANS COMPRISE AT LEAST 25 PERCENT OF A BANK'S LOAN PORTFOLIO. AND I FEEL THERE SHOULD BE AN AGGREGATE LIMIT ON THE AMOUNT OF LOSSES DEFERRED - TO 75% OF THE BANK'S CAPITAL, FOR EXAMPLE.

IN MY VIEW, A BANK SHOULD HAVE TO AFFIRMATIVELY SUBMIT A PLAN TO THE APPROPRIATE REGULATORY AGENCIES OUTLINING HOW THE AMORTIZATION PROGRAM WOULD AFFECT THE BANK AND STEPS THE BANK INTENDS TO TAKE TO AVOID FURTHER DETERIORATION IN ITS FINANCIAL CONDITION. IF THE REGULATORS ARE OF THE OPINION THAT THE BANK WILL INEVITABLY FAIL EVEN IF ALLOWED TO DEFER LOAN LOSSES, THERE

SEEMS TO ME TO BE NO REASON ALLOW A BANK TO UTILIZE THIS LOAN LOSS DEFERRAL APPROACH. THE REGULATORS CAN UNDOUBTEDLY DEVELOP OTHER WAYS TO TARGET THE AVAILABILITY OF AN AMORTIZATION OF LOAN LOSS PROGRAM - SUCH AS LIMITING SALARY INCREASES OR PREVENTING DIVIDEND DISTRIBUTIONS DURING THE PERIOD OF PARTICIPATION IN THE PROGRAM - AND I URGE THAT THEY BE GIVEN AUTHORITY TO PUT SOME TEETH INTO THE PROGRAM. I WILL LEAVE IT TO THEM TO COME UP WITH THE SPECIFICS.

EXPANDED FDIC AUTHORITY TO PREVENT BANK CLOSINGS

I HAVE BRIEFLY DISCUSSED WITH FDIC CHAIRMAN BILL SEIDMAN WAYS IN WHICH THE FDIC COULD ACT MORE QUICKLY WHERE A BANK FAILURE IS IMMINENT. AT PRESENT, THE FDIC MUST SIMPLY WAIT FOR THE BANK TO CLOSE BEFORE THEY CAN ACT. I ADVOCATE GIVING THEM AUTHORITY TO ACT PRIOR TO CLOSING. HOPEFULLY THEY CAN DEVELOP A SYSTEM OF LOCATING POTENTIAL BIDDERS BEFORE THE DOORS TO THE BANK ARE CLOSED AND DEPOSITORS ARE FRIGHTENED. IN SOME CASES IT MAY BE MORE COST EFFICIENT FOR THE FDIC TO ACTUALLY PAY A BANK TO TAKE OVER THE LOAN PORTFOLIO RATHER THAN TO MANAGE THE PORTFOLIO ITSELF.

MORE BUYERS OF TROUBLED INSTITUTIONS

IF WE ARE SERIOUS ABOUT KEEPING THE COMMUNITY BANK OPEN, WE MUST EXAMINE THE RESTRICTIONS PRESENTLY PLACED ON POTENTIAL BUYERS OF THE BANK. IN SOME CASES WHERE BRANCHING IS NOT ALLOWED, THE BRANCHING REQUIREMENTS EFFECTIVELY SERVE TO CLOSE THE COMMUNITY BANK. HOPEFULLY THESE PROBLEMS CAN BE CURED BY THE STATE LEGISLATURES INVOLVED. AND BANKS OR THRIFTS OF LESS THAN $500 MILLION ARE OFTEN PREVENTED FROM ACQUIRING A FAILED BANK, EVEN WHERE THERE ARE NO BUYERS AT ALL AND THE BANK IS DESTINED TO CLOSE.

WHILE MANY OF THE BANKERS IN MY STATE WILL DISAGREE WITH ME - FOR REASONS THAT I DO NOT TOTALLY UNDERSTAND - WE MUST CONSIDER ALLOWING AN EXPANDED NUMBER OF INSTITUTIONS TO ACQUIRE FAILED AND FAILING BANKS - IF, THAT IS, THE ALTERNATIVE IS THE EVAPORATION OF BANKING SERVICES IN A GIVEN COMMUNITY. BANKS AND THRIFTS BOTH, WITHIN AND OUTSIDE THE STATE, SHOULD BE GIVEN THE RIGHT TO PROVIDE FINANCIAL SERVICES BEFORE THE BANK IS PERMANENTLY CLOSED. I BELIEVE WE CAN FASHION PROTECTION FOR LOCAL BIDDERS BY PERHAPS EVEN GIVING THEM THE RIGHT TO MATCH ANY OUTSIDE BID.

THIS IS AN EMOTIONAL ISSUE AMONG MANY BANKERS. BUT AGAIN, I HAVE SEEN ENTIRE TOWNS DRY UP WHEN THE BANK CLOSES. AND I AM MORE CONCERNED ABOUT MAINTAINING BANKS, AND COMMUNITIES, THAN BANKERS.

CONCLUSION

MR. CHAIRMAN, I HAVE JUST TOUCHED ON A COUPLE OF AREAS. THERE ARE A VARIETY OF THINGS WE CAN DO TO AID TROUBLED COMMERCIAL BANKS. I WOULD NOTE THAT THE AMERICAN BANKERS ASSOCIATION AND THE INDEPENDENT BANKERS ASSOCIATION DON'T ALWAYS

SEE EYE TO EYE - AS THE CHAIRMAN WELL KNOWS - BUT THEY HAVE FORMED A TASK FORCE WHICH HAS RECOMMENDED AN AMORTIZATION OF LOAN LOSS PROGRAM AS THE CENTERPIECE OF THEIR RELIEF PACKAGE. IN THE COURSE OF THESE HEARINGS, THE COMMITTEE WILL UNDOUBTEDLY DISCUSS A VARIETY OF ADDITIONAL WAYS TO PROVIDE RELIEF TO COMMERCIAL BANKS. SOME HAVE SUGGESTED THAT THE SITUATION JUSTIFIES A BROAD "NEW POWERS" BILL. AND WHILE SOME DIVERSIFICATION IN LENDING PRACTICES MAY HAVE, IF UTILIZED JUDICIOUSLY, HELPED PREVENT THE CURRENT SITUATION FROM DEVELOPING, THAT IS NOT THE SOLUTION TO THE PROBLEM NOW THAT WE'RE HERE.

SOONER OR LATER, THE POINT WILL BE MADE THAT THE BEST AND FAIREST WAY TO HELP THE BANK IS TO HELP THE BORROWER. WE WILL UNDOUBTEDLY HAVE AN OPPORTUNITY TO DISCUSS INTEREST RATE BUY-DOWN SCHEMES. I HAVE MYSELF BEEN EXPLORING A PRINCIPAL WRITE-DOWN SCHEME COMBINED WITH A GUARANTEE. ALL OF THESE COST MONEY, DIRECTLY OR INDIRECTLY. BUT WE'RE NOT TALKING ABOUT THE EXTENSION OF ADDITIONAL FARM CREDIT HERE. WE'RE TALKING ABOUT WAYS TO ENSURE THE CONTINUATION OF BANKING SERVICES IN COMMUNITIES ACROSS ECONOMICALLY DISTRESSED PARTS OF AMERICA.

BUT IF WE CAN REACH SUBSTANTIAL AGREEMENT IN SOME OF THESE OTHER AREAS, I AM NOT ADVERSE TO EXPLORING THEM AS PART OF A BILL TO AID TROUBLED COMMERCIAL BANKS. OUR FIRST PRIORITY SHOULD BE AGREEING ON MEASURES WHICH CAN HELP PREVENT THE CLOSING OF BANKS WHERE POSSIBLE. AND THE BANKING EXPERTS IN MY STATE TELL ME THAT A SIMPLE LOAN LOSS AMORTIZATION PROGRAM OVER 5 YEARS WOULD ALLOW MOST BANKS THERE TO HOLD ON UNTIL WE FIND OUT WHETHER IN FACT THE ECONOMY WILL IMPROVE. THAT IS A GAMBLE WE SHOULD TAKE, IN MY

SO I URGE THE COMMITTEE TO ACT QUICKLY ON A BILL WHICH HOPEFULLY DOESN'T CONTRIBUTE TO THE DEFICIT PROBLEM AND WHICH CAN BE ACTED ON QUICKLY. THOSE OF US WITH A DIRECT INTEREST IN THE SUBJECT WILL CONTINUE TO PARTICIPATE IN THE DEVELOPMENT OF A PACKAGE WHICH CAN HELP STABILIZE BANKS AND COMMUNITIES IN THE SHORT TERM. BUT AGAIN, WE MUST DECIDE NOW WHETHER WE WANT TO TRY TO PROVIDE SOME RELIEF WHICH WILL KEEP COMMUNITY BANKS OPEN - OR WHETHER WE WANT TO JUST HAVE AN ISSUE TO TALK ABOUT. I SUGGEST WE TRY TO BE HELPFUL.

The CHAIRMAN. Senator Dole, I thank you for your appearance and I would say to you that we will conclude these hearings next week. We have another day of hearings on the March 11, and then we will move as rapidly as possible.

Now it is my intention to move ahead as soon as we can to a markup. It is my feeling, although I have not polled every member of the committee, that we are not too far apart. Senator Dixon has always been very easy to work with on this committee and although he has a bill, I'm sure he recognizes there could be some adjustments in that bill. Congressman Bruce, on the House side, as well.

I think it's possible that we can get together on a bill and if we do I would hope that it could come out of this committee unanimously and that we would also take a position then that we would oppose any amendments on the floor.

Senator DOLE. That would be a key. Otherwise, there's going to be, as I said, sort of a Christmas tree approach. If the members of this committee on both sides serve notice on the rest of us, myself included, that you did your best, this is the product, let's see what happens—my view is there wouldn't be any amendments successfully offered.

The CHAIRMAN. Well, as you know, in the years I've been chairman of this committee, I have never liked legislative Christmas trees.

Senator DIXON. Mr. Chairman——

The CHAIRMAN. Let me just conclude and then I'll turn to you. Many times I have stood on the floor and said, "I will propose to table any amendment, even if it's one that I like." I have done that before and I think that under the circumstances, with the need for some haste and spring planting coming along, the last thing we need to do is to get out there and have some giant bill emerge after we have produced one in the committee.

So I appreciate your comments and your willingness of support and that's what we will attempt to do.

Senator Dixon.

Senator DIXON. Mr. Chairman, before the majority leader leaves, if I may comment and also express my appreciation to the Chair and to the majority leader. As we all know, I offered the 30-year amortization amendment to the 1985 farm bill which lost on a close rollcall 44-to-47 vote, and then I was prepared to offer something similar on the Farm Credit System legislation and the Chair and majority leader both assured me that if I did not do so at that time there would be appropriate hearings as soon as possible this year, and I want to thank them both for delivering on that promise and particularly the Chair, who's in control of this committee, and I want to express to both of them my personal appreciation for their support of this concept.

I appreciate the fact that there will be some modifications and I am prepared, as a member of the loyal opposition on this side, to support whatever reasonable concept we can all come together upon and to support that with all the enthusiasm at my command on the floor of the Senate, and I do want to express the personal appreciation of many of us involved in this process to the Chair and to the majority leader.

Senator DOLE. Well, thank you. And I think we can find the time. We ought to be able to do it in a couple of days, wouldn't you think, if we had an agreement?

Thank you very much.

The CHAIRMAN. Thank you, Senator Dole.

Mr. Secretary, please proceed.

STATEMENT OF CHARLES O. SETHNESS, ASSISTANT SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. SETHNESS. Mr. Chairman, and members of this distinguished committee, I am pleased to have this opportunity to present the administration's views on the difficulties facing insured agricultural banks. I look forward to working closely with you on this and other financial institutions issues.

I would propose to summarize my statement orally with the understanding that my full written statement will be placed in the record.

The CHAIRMAN. Absolutely. We would be happy to put your full statement in the record.

Mr. SETHNESS. The problems in our agricultural sector have created serious financial and personal difficulties for many farmers.

FED REPORTS 80 TO 85 PERCENT OF FARMERS ARE IN GOOD SHAPE

We are alert to these problems. Nevertheless, we also must examine this issue in a fair perspective, given the many demands on the Federal Government's resources today. For example, according to the Federal Reserve, 80 to 85 percent of all farmers remain in sound financial condition.

Agriculture is going through a major transition in America. And it must do so if it expects to compete effectively for export markets. The new farm bill authorizes the expenditure of at least $50 billion over the next few years to ease the way. The lower dollar will help, too.

Despite the difficult near-term outlook, the administration believes the bank regulatory structure and the farm assistance programs currently in place make the problems at agricultural banks manageable. We believe, however, that it is critical for the bank regulatory agencies to continue to work constructively with farm banks on their problems and the concerns of their borrowers. We will strive to assist the regulators in this task.

The remainder of my statement presents an overview of the nature of the financial problems of agricultural banks; discusses how recent legislation strengthening the Farm Credit System and the programs of the Farmers Home Administration benefit these banks; and, third, addresses the major special assistance programs that some agricultural bankers are requesting.

First, as to the financial problems of agricultural banks. Most agricultural banks are still sound. But the number of individual banks with problem loans is increasing. The agricultural banking sector will continue to face trying times until agricultural incomes and land prices stabilize. The FDIC and the Office of the Comptroller of the Currency have stated, however, that they do not believe

agricultural bank problems will affect the safety and soundness of the banking system.

The banking sector's direct exposure to the agricultural sector is limited to slightly over 2 percent of total commercial bank assets. Only about 12 percent of total farm debt, about $24 billion in direct loans, is held by almost 4,000 agricultural banks.

Historically, agricultural banks have enjoyed higher earnings, higher capital levels, and lower loan losses than nonagricultural banks. Therefore, in spite of their present problems, agricultural bank capital is still reasonably strong. On September 30, 1985, 50 percent of the agricultural banks had reported capital-to-asset ratios of over 10 percent, and only 1 percent had reported capital below 6 percent. As a group, their capital-to-asset ratio of 9.75 percent was well above the average of 7.5 percent for the entire banking system.

Troubled agricultural banks are concentrated geographically. As several people have noted, 62 agricultural banks failed in 1985, just over 1 percent of all farm banks. But 52 of the failed agricultural banks, were located in the Midwest and Great Plains States, where the farm economy has been hit most severely by the weak export market for American farm products. The failed banks are generally extremely small. The average asset size of failed agricultural banks in 1985 was just under $20 million.

We must be careful not to suggest that all bank failures deprive small communities of their local lenders. Late last year, the FDIC testified in the House that 40 of the 50 agricultural banks that had failed as of that time had been reopened, either as freestanding banks or as branches of another bank. This fact does not deny the hardship to the banker and some problem borrowers. But clearly we have ways to maintain credit in rural towns and communities without resorting to possibly costly solutions to assist all troubled banks.

ASPECTS OF THE 1985 ACT

I'd like to turn now to the Farm Credit Amendments Act of 1985. Late last year, I was deeply involved with the drafting and enactment of the Farm Credit Amendments Act of 1985, which the President signed into law on December 23 of last year. Because this legislation moved so rapidly, many people remain only partially informed about its contents and effects. I would like to describe the act briefly for you because agricultural banks will benefit notably from its passage.

The act strengthens the Farm Credit System [FCS] in three major ways. First, it enables the FCS to help itself by transferring its substantial surplus to those districts in greatest need of capital. This additional capital will help hard-pressed FCS districts to absorb losses and work with debt-stressed farmers. Second, the act reforms the Farm Credit Administration by making it an arms-length regulator and granting it powers to ensure that FCS lenders operate in a safe and sound manner. Third, the new law gives a carefully restricted backstop to the FCS to ensure its ability to fund itself in the capital markets.

Some agricultural bankers have contended that since Congress enabled the Farm Credit System to help itself, Congress should help them. This reasoning is highly ironic. It ignores: one, the significant differences between the FCS and farm banks, as well as the nature of the help FCS received; and two, the critical fact that a viable FCS helps agricultural banks in many ways.

First, the FCS differs from banks. It is a privately owned cooperative that is chartered by Congress to supply credit and closely related services to farmers and ranchers. The System's approximately 800 constituent units are linked together by: one, their reliance on consolidated borrowings in public debt markets—about $68 billion of debt outstanding; two, the joint and several liability of the 37 System banks that play the key intermediary role; three, loss-sharing contracts; and four, their common legal establishment under the Farm Credit Act of 1971.

The Farm Credit System is chartered by Congress to serve only one sector of our economy—agriculture. It does not have the diversified asset powers that banks enjoy. In addition, the FCS raises its money in the bond markets, whereas banks fund themselves through deposits—with their liquidity assured by deposit insurance and the Fed's discount window. If bond market investors lose confidence in FCS, there is no FDIC to stop the run.

One major assistance given the FCS by the 1985 act was the authority to shift surplus capital from healthy institutions to the weaker ones—something that the commercial banks are not likely to propose for themselves. Moreover, the package included a new requirement that FCS lenders must prepare independently audited financial statements according to generally accepted accounting principles, just when the agricultural banks are seeking to loosen their accounting standards.

Second, there are a number of ways in which the viable FCS helps agricultural banks.

First, commercial banks are the largest single holder of FCS bonds. If these bonds were to lose value, many agricultural banks would suffer sizable losses.

Second, FCS fills an important lending niche that most agricultural banks avoid—making long-term land loans. If FCS funds were not available, the banks would be pressured to meet this need of farmers. Federal Land Banks currently hold about $49 billion of farm debt—23 percent of the total outstanding. This accounts for 60 percent of farm mortgage finance.

Third, if the Farm Credit System could not roll over its debt, it would have to liquidate its farm loans, depressing the value of farm land and other farm assets even further. Such a decline in farm collateral values would severely damage agricultural banks.

Finally, FCS's owners are its farmer-borrowers. If they lose the value of their stock because FCS cannot pay its debts, many farmers will be unable to repay their loans from agricultural banks.

The Farm Credit System reported a $2.7 billion loss for 1985, leaving it with $3.4 billion of earned surplus and loan loss reserves of $3.2 billion. The System's large loss has not disturbed the market for the bonds it sells to raise funds.

RELIEF FROM THE FHA

The Farmers Home Administration [FHA], an agency within the U.S. Department of Agriculture that holds 13 percent of total farm debt, also relieves the pressure on agricultural banks in several ways. Farmers Home Administration is a lender of last resort for farmers, other rural residents, and rural communities unable to obtain credit at affordable rates and terms from commercial lenders.

The Farmers Home major loan programs, which I describe in my testimony more fully, include farm operating loans, long-term farm ownership loans, and disaster emergency loans.

In addition, in September 1984, the administration introduced the Farmers Home Administration Debt Reduction Program to help farmers and banks. Under this program, the Farmers Home guarantees up to 90 percent of renegotiated loans on which a bank has written down the principal and/or reduced the interest charges sufficiently for the borrower to be able to service his debt. There has been surprisingly little use of this program by the banks.

The newest Farmers Home program to assist farmers and their bankers was authorized by the 1985 farm bill. The act provides an Interest Rate Reduction Program for loans made by commercial banks and guaranteed by Farmers Home. Under the program, Farmers Home matches up to 2 percent of interest rate reductions by commercial banks if the loan will cash-flow at the reduced rate.

Finally several special assistance measures proposed by the agricultural banking community and others. These include issuing net worth certificates, permitting extended loan loss writedown periods, creating additional programs for principal or interest buydowns, placing a moratorium on foreclosures and relaxing State laws to ease the preservation of banking services to communities with a failing bank.

I discuss each of these proposals in my testimony. Now, I'd like to touch on just one that's frequently ignored.

Some restrictive State laws—pertaining to farm ownership, unit banking, and out-of-State acquisitions—exacerbate current problems. Restraints on farm ownership reduce the demand for, and hence the price of, farm land. Unit banking States limit the ability of banks to weather losses through offsetting profits from a more diversified lending base. Moreover, States that still require acquirers of failing banks to run the banks as stand-alone operations make it hard or impossible for the FDIC to arrange purchases that could maintain banking service for many communities. Neither our rural citizens nor the FDIC can continue to afford barriers to branching in emergency situations.

Similarly, the emergency acquisition provisions of the Garn-St Germain Act of 1982 severely restrict acquisitions of troubled banks across State lines: The bank must have failed, and must have assets of at least $500 million. This is populism for a few bankers, but not for farmers, not for people in small towns, and not for the other banks who must finance the FDIC. The emergency acquisition provisions will expire on April 15 unless the Congress extends them. If we want to manage the failure of small banks better

so borrowers and small savers are helped, Congress should eliminate these restrictions and extend the emergency provisions.

In conclusion, we will seek full utilization of existing programs that give temporary aid to basically sound farmers and farm bankers who are encountering short-term problems. These supports are not insignificant. The Farm Credit System has just chartered its new Capital Corporation in order to channel System reserves where needed most. The Farmers Home Administration has already begun to put in place its new $490 million interest rate buydown program, and its other lending programs can continue to help both farmers and bankers.

We also will continue to work with the bank regulators to consider the best means possible to ease the plight of farmers and bankers during this exceedingly difficult transition period. We must recognize, however, that regulators also have a long-term duty to ensure that banks are soundly run and capitalized, so as to protect borrowers, lenders, and the deposit insurance funds.

The new special assistance programs that have been proposed are, for the most part, problematical in many respects. There is no panacea. In varying degrees, the proposals: (1) run the risk of actually weakening the banking industry over time; (2) will likely be very expensive either now or in the future; and (3) pose serious questions of equity as between lenders to various sectors of the economy.

We recognize the seriousness of the agricultural bank problem to important areas of the Nation. We will keep at it. We will consider carefully all proposals to assist agricultural banks and will continue to work with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Department of Agriculture, and this body to develop approaches essential to the long-term well-being of the agricultural credit sector.

Mr. Chairman, that concludes my statement. I would be happy to answer any questions the committee may have.

[The complete prepared statement follows:]

STATEMENT OF THE
HONORABLE CHARLES O. SETHNESS
ASSISTANT SECRETARY OF THE TREASURY FOR DOMESTIC FINANCE
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
THURSDAY, MARCH 6, 1986

Mr. Chairman, and Members of this Distinguished Committee:

I am pleased to have this opportunity to present the Administration's views on the difficulties facing insured agricultural banks. I look forward to working closely with you on this and other financial institutions issues.

The problems in our agricultural sector have created serious financial and personal difficulties for many farmers. These problems have made it hard for some farmers (especially the most highly-leveraged producers) to repay their loans. As a result, there has been a substantial increase in the number of nonperforming assets at agricultural banks and other farm lending institutions (e.g., the Farm Credit System).

We are alert to these problems. Nevertheless, we also must examine this issue in a fair perspective, given the many demands on the Federal Government's resources today. For example, according to the Federal Reserve, 80 to 85 percent of all farmers remain in sound financial condition.

Agriculture is going through a major transition in America. And it must do so if it expects to compete effectively for export markets. The new Farm Bill will spend at least $50 billion over the next few years to ease the way. The lower dollar will help, too.

Current USDA economic projections anticipate several more years of severe pressure on farmers, rural communities and agricultural lending institutions. But USDA expects the capacity-demand mismatch to improve and land values appear to be bottoming out in many parts of the country.

Despite the difficult near-term outlook, the Administration believes the bank regulatory structure and the farm assistance programs currently in place make the problems at agricultural banks manageable. We believe, however, that it is critical for the bank regulatory agencies to continue to work constructively with farm banks on their problems and the concerns of their borrowers. We will strive to assist the regulators in this task.

The remainder of my statement: (1) presents an overview of the nature of the financial problems of agricultural banks; (2) discusses how recent legislation strengthening the Farm Credit System (FCS) and the programs of the Farmers Home Administration (FmHA) benefit these banks; and (3) addresses the major special assistance programs that some agricultural bankers are requesting.

Financial Problems of Agricultural Banks

Most agricultural banks* are still sound. But the number of individual banks with problem loans is increasing. The agricultural banking sector will continue to face trying times until agricultural incomes and land prices stabilize. The FDIC and OCC have stated, however, that they do not believe agricultural bank problems will affect the safety and soundness of the banking system.

The banking sector's direct exposure to the agricultural sector is limited to slightly over two percent of total commercial bank assets. Only about 23 percent of total farm debt, (i.e., $48 billion in direct loans) is held by commercial banks.** About half of that commercial bank credit ($24 billion) is held by banks that are diversified and thus better able to absorb nonperforming agricultural loan losses. The other $24 billion of commercial bank agricultural loans is held by almost 4,000 agricultural banks.

---

* Agricultural banks are defined here as those with over 25 percent of their gross loans in agricultural credits (loans secured by farm land, loans to finance agricultural production and other loans to farmers).

** The Federal Reserve Board estimates that at year-end 1985 total U.S. farm debt equaled about $210 billion. Commercial banks held about 23 percent of the total farm debt, the Farm Credit System (FCS) held about 29 percent, the Farmers Home Administration (FmHA) held about 13 percent, life insurance companies and the Commodity Credit Corporation held about 13.5 percent, and individuals and others held the remaining 21.5 percent.

Historically, agricultural banks have enjoyed higher earnings, higher capital levels, and lower loan losses than nonagricultural banks. Therefore, in spite of their present problems, agricultural bank capital is still reasonably strong. On September 30, 1985, 50 percent of the agricultural banks had reported capital-to-asset ratios of over 10 percent, 37 percent had reported capital between 8 and 10 percent, 12 percent had reported capital between 6 and 8 percent and only 1 percent had reported capital below 6 percent. As a group, their capital-to-asset ratio of 9.75 percent was well above the average of 7.5 percent for the entire banking system.

Obviously, there is a great disparity in the condition of individual agricultural banks. There may also be a number whose apparently high capital does not reflect fully the continued deterioration in their loan portfolios. In addition, the troubled banks are concentrated geographically. Sixty-two agricultural banks failed in 1985 -- just over one percent of all farm banks. But 52 were located in the Midwest and Great Plains states, where the farm economy has been hit most severely by the weak export market for American farm products. The failed banks are generally extremely small; the average asset size of failed agricultural banks in 1985 was just under $20 million.

We also must be careful not to suggest that all bank failures deprive small communities of their local lenders. Late last year, the FDIC testified in the House that 40 of the 50 agricultural banks that had failed as of that time had been reopened -- either as free-standing banks or as branches of another bank. This fact does not deny the hardship to the banker and some problem borrowers. But clearly we have ways to maintain credit in rural towns and communities without resorting to possibly costly solutions to assist all troubled banks.

The FDIC expects that in 1986 farm bank problems will continue at levels at least equal to those experienced during the recent past. It estimates that losses on total farm loans for all lenders will range from about $7 billion to $20 billion over the next three to four years. Farm loan charge-offs at commercial banks are estimated to have reached $1.5 billion in 1985. When combined with farm loan losses at other lenders, the total for 1985 would exceed $3.0 billion.

Most agricultural banks are handling their problems well and remain sound institutions. Farmers, their bankers, and the bank regulators are working together to solve loan repayment problems. Nevertheless, if the farm economy does not improve over the next few years, many marginal farmers and their banks will continue to face hard times.

Farm Credit Amendments Act of 1985

Late last year, I was deeply involved with the drafting and enactment of the Farm Credit Amendments Act of 1985, which the President signed into law on December 23, 1985. Because this legislation moved so rapidly, many people remain only partially informed about its contents and effects. I would like to describe the Act briefly for you, because agricultural banks will benefit notably from its passage.

The Act strengthens the Farm Credit System (FCS) in three major ways. First, it enables the FCS to help itself by transferring its substantial surplus to those districts in greatest need of capital. This additional capital will help hard-pressed FCS districts to absorb losses and work with debt-stressed farmers. Second, the Act reforms the Farm Credit Administration by making it an arms-length regulator and granting it powers to ensure that FCS lenders operate in a safe and sound manner. Third, the new law gives a carefully restricted "backstop" to the FCS to ensure its ability to fund itself in the capital markets.

Some agricultural bankers have contended that since Congress enabled the Farm Credit System to help itself, Congress should help them. This reasoning is highly ironic. It ignores: (1) the significant differences between the FCS and farm banks, as well as the nature of the help FCS received; and (2) the critical fact that a viable FCS helps agricultural banks in many ways.

First, the FCS differs from banks. It is a privately owned cooperative that is chartered by Congress to supply credit and closely related services to farmers and ranchers. The System's approximately 800 constituent units are linked by: (1) their reliance on consolidated borrowings in public debt markets (about $68 billion outstanding); (2) the joint and several liability of the 37 System banks that play the key intermediary role; (3) loss-sharing contracts; and (4) their common legal establishment under the Farm Credit Act of 1971.

The FCS is chartered by Congress to serve only one sector of our economy: agriculture. It does not have the diversified asset powers that banks enjoy. In addition, the FCS raises money in the bond markets, whereas banks fund themselves through deposits -- with liquidity assured by deposit insurance and the Fed's discount window. If bond market investors lose confidence in FCS, there is no FDIC to stop the run.

One major assistance given the FCS by the 1985 Act was the authority to shift surplus capital from healthy institutions to the weaker ones -- something that the commercial

banks are not likely to propose for themselves. Moreover, the package included a new requirement that FCS lenders must prepare independently audited financial statements according to generally accepted accounting principles (GAAP) -- just when the banks are seeking to loosen their accounting standards.

Second, a viable FCS helps agricultural banks in at least four ways:

(1) Commercial banks are the largest single holder of FCS bonds; if these bonds were to lose value, many agricultural banks would suffer sizable losses.

(2) FCS fills an important lending niche that most agricultural banks avoid: making long-term land loans. If FCS funds were not available, the banks would be pressured to meet this need of farmers. Federal Land Banks currently hold about $49 billion of farm debt (23 percent of the total outstanding), accounting for about 60 percent of farm mortgage finance.

(3) If FCS could not roll over its debt, it would have to liquidate its farm loans -- depressing the value of farm land and other farm assets even further. Such a decline in farm collateral values would severely damage agricultural banks.

(4) Finally, FCS's owners are its farmer-borrowers. If they lose the value of their stock because FCS cannot pay its debts, many farmers will be unable to repay their loans from agricultural banks.

This winter the FCS forecasted that its total losses will be in the range of $5-$6 billion over years 1985 through 1987. As of September 30, 1985, FCS had $5.5 billion in earned surplus, $5.3 billion in borrower stock, and $1.6 billion in loss reserves.

FCS reported a $2.7 billion loss for 1985, leaving $3.4 billion of earned surplus and loan loss reserves of $3.2 billion. The System's large loss has not disturbed the market for the bonds it sells to raise funds. Since Congress passed the Farm Credit Amendments Act, the yields on the bonds have narrowed to between 30 and 55 basis point above comparable Treasury bill yields, and even narrower spreads over the yields for other "agency" borrowers. These borrowing rates are comparable to those for healthy major corporate borrowers.

Benefits of the Farmers Home Administration Programs

The Farmers Home Administration (FmHA) -- an agency within the U.S. Department of Agriculture that holds 13 percent of total farm debt -- also relieves the pressure on agricultural

banks in several ways. FmHA is a lender of last resort for farmers, other rural residents, and communities unable to obtain credit at affordable rates and terms from commercial lenders. At the end of September 1985, the agency had about 270,000 farm and ranch borrowers.

The FmHA's major farm loan programs include:

(1) Farm operating loans. These are usually one-year loans to help farmers cover the cost of producing a crop. In fiscal 1985, FmHA obligated $4.7 billion for operating loans, about $1.1 billion of which was for guaranteed loans.

(2) Farm ownership loans. These are long-term loans to assist in acquiring farms. The FmHA made $720 million in ownership loans in fiscal 1985.

(3) Disaster emergency loans. These are designed to help farmers recover from the effects of a natural disaster such as drought or flood. The budget for emergency loans varies according to the number of officially declared disasters; in fiscal 1985 and 1984, FmHA made $491 million and more than $1 billion in emergency loans, respectively.

During fiscal 1985, the Secretary of Agriculture, employing his discretionary authority, provided special credit assistance to over 152,000 FmHA farm borrowers, more than double the number of borrowers in 1984. Special credit assistance included deferral of loan payments, rescheduling, and subordination of liens to commercial lenders in the private sector.

In addition, in September 1984, the Administration introduced a FmHA debt reduction program to help farmers and banks. Under this program, the FmHA guarantees up to 90 percent of renegotiated loans on which a bank has written down the principal and/or reduced the interest charge sufficiently for the borrower to service his debt. There has been surprisingly little use of this program by the banks.

The newest FmHA program to assist farmers and their bankers was authorized by the 1985 Farm Bill. The Act directs the Secretary of Agriculture to establish an interest rate reduction program for loans made by commercial banks and guaranteed by the FmHA. Under the program, a commercial lender must reduce the interest rate on a farm loan by a specified minimum amount to allow a farmer to have a positive cash flow. Then the Secretary can make a payment to the lender in an amount equal to up to 50 percent of the cost of the interest rate reduction. This payment may not exceed the cost to the government of reducing the rate by more than two percent. The term of the interest rate reduction contract may not exceed the remaining loan term, or three years, whichever is shorter.

The amount of funds available for this program can total up to $490 million; the program runs until September 30, 1988. Clearly, banks with problem loans and their farmer-borrowers have much to gain from this sizable expenditure program.

Proposed Special Assistance Programs for Agricultural Banks

There are several special assistance measures proposed by the agricultural banking community and others. These include: (1) issuing net worth certificates; (2) permitting extended loan write-down periods; (3) creating additional programs for principal or interest rate buydowns; (4) placing a moratorium on foreclosures; and (5) relaxing state laws to ease the preservation of banking services to communities with a failing bank. I will review each of these proposals briefly.

Net Worth Certificates (NWC). NWCs were first authorized by the Garn-St Germain Act of 1982. The Act permits the FDIC and FSLIC to purchase NWCs from qualified insured thrift institutions in exchange for promissory notes, in order to assist institutions experiencing losses due mainly to interest rate spread problems. Since NWCs qualify as capital for regulatory purposes, they in theory allow thrifts time to restore capital to adequate levels.

Some members of the banking industry have asked Congress to expand the program to provide paper capital to agricultural banks -- this time to offset losses on problem loans, not losses due to negative interest margins.

The major disadvantage of this program is that the ultimate costs could be very high. If the farm economy did not turn around soon, the FDIC would have to pay off many of the holders of the promissory notes at substantial cost. Moreover, the managers of institutions kept alive in this fashion have an incentive to take greater risks: If their gamble pays off, they stay in business; if they lose, the FDIC would pick up the tab.

The program would also disguise the true state of capital adequacy and violate generally accepted accounting principles. As we have seen in the case of the thrifts, "creative" bookkeeping can undermine confidence in a whole industry. In addition, while in theory this program could be directed only at fundamentally sound banks in temporary trouble, in practice it is difficult to set this criterion and to stick to it.

Permitting Extended Loan Write-Down Periods. A second type of proposal would supercede accounting rules by permitting banks to extend loan write-downs over a number of years. Currently, a bank must book a loan loss when it determines that a portion of the loan is no longer likely to be paid back.

Allowing a bank to amortize loan losses over an extended period is really the same as allowing it to overstate its capital position. This approach may undermine the public's knowledge of, and confidence in, a bank's financial condition. It also runs the risk of increasing the FDIC's costs by keeping fundamentally insolvent institutions alive with no real capital at risk.

The advantage of the loss deferral proposal over NWCs is that NWCs involve a promissory note by the FDIC. If the bank fails, the FDIC must pay off the note. The loss deferral program simply overstates the capital buffer between the losses and the FDIC.

The Comptroller's Office is examining the risks and benefits of a variant of loan loss amortization. In effect, it may be able to "regularize" a capital rebuilding schedule for banks whose capital has fallen below supervisory standards, but which have reasonably good prospects for recovery over time. If workable, this approach may help limit credit contraction; otherwise, percentage lending limits may force a bank with a reduced capital base to reduce loans outstanding.

Principal or Interest Rate Buydowns. The Administration's newly authorized $490 million program for the FmHA offers an example of how an interest rate buydown can work. The Federal Government and the lender share the cost of reducing the principal or debt service on a loan -- to an amount the borrower can manage. This type of program increases the likelihood that a satisfactory work-out can be arranged between the farmer and the lender.

This type of program may encounter problems, however, if a farmer has several lenders. If one lender decides to reduce his loan's interest rate so as to return the borrower to a positive cash flow, the other lenders will have improved their positions at the first lender's expense. Requiring coordination between the lenders would help distribute losses more equitably, but could involve administrative problems.

The Administration wants to make the existing buydown program work. FmHA published regulations for it in the Federal Register on February 25, 1985; and farmers and bankers can take advantage of it immediately.

Given the cost of this approach, it would be imprudent to expand outlays before we even have seen how the first sum works. Neither Congress nor the Administration can accept a budget busting addition now.

The CHAIRMAN. Thank you, Mr. Secretary.

Testifying after you today will be representatives of the ABA, the IBAA, and the ACLI. While the three seldom agree on any issues, they all recommend that we pursue development of a secondary market for farm loans originated by commercial banks.

Would you comment on their recommendation?

SECONDARY MARKET FOR FARM LOANS

Mr. SETHNESS. I'm sure that it would be very helpful to the agricultural bankers if it were possible to develop a secondary market in farm loans, whether it be long-term land loans or operating paper. And I, for one, would be quite delighted if such a market developed.

I am concerned that the success of a secondary market in anything has everything to do with the credit quality of the underlying paper, which gets turned into securities to be sold in the secondary market to ultimate investors. And my understanding from my intensive 6-month course in agricultural lending is that the problem with the kinds of loans that we would like to see a secondary market in is that they are not of the credit quality, for the most part, that would be readily acceptable in the securities market.

The proposals to work toward a secondary market that I've seen tend to include credit support and enhancement to make up for that shortfall in basic credit quality, and the most frequently mentioned source to lend that credit enhancement is the Federal Government. That is another further federalization of the credit markets, which we are not in favor of, and it would involve severe risks of having budget costs for the Government.

The CHAIRMAN. As a way to stabilize farm real estate values, the ABA in their testimony recommend that the existing law requiring banks to divest themselves of agricultural real estate within 5 years be extended to 10 years with an additional 5-year discretion granted to the Comptroller.

Obviously, the theory is based on selling land in a declining market just exacerbates the problem and further deflates asset values.

How would the administration react to a proposal to extend that period of time?

Mr. SETHNESS. It's not something that I have thought a good deal about or that I think that there would be an administration position on at this moment. I know that the FDIC has proposed flexibility for asset holding periods, and I have not had an opportunity to talk with the Comptroller's Office about how they would react to that concept.

The CHAIRMAN. Well, I think what we're looking at—no one wants a bailout. No one wants big impacts on the budget with all of the other difficulties we're having. But it seems to me that there should be some flexibility. To force banks to dispose of assets when they are at a low point doesn't make a great deal of sense to me when we're talking about safety and soundness and how we can help them. On the one hand, say, fine, we don't care if land values are really down, dump them now.

It makes some sense to me to give some flexibility to let them wait and hopefully that those land values will come back up and there's no cost there to the Government.

Mr. SETHNESS. Well, this is part of the whole package of regulators working as constructively as possible with banks, trying to avoid the risk that banks are holding something that appears to be at a low and then turns out to go lower, which could create greater problems over time.

I think this is something that bears further consideration.

The CHAIRMAN. In your statement you refer to the FmHA Debt Reduction Program the administration introduced in September 1984 and report, "There has been surprisingly little use of this program by the banks."

Do you have any reasons that they have not used the program extensively?

Mr. SETHNESS. I can't be sure. The only things that I have heard on that were that bankers were reluctant to do the loan restructuring that would be required to qualify for the program.

There are tremendous differences in different parts of the country as to how aggressively the program has been pursued.

Demand under this program is up sharply this year, as a year-to-year comparison, but it's up from a very low base. Last year at this time there had been requests for about 40 million dollars' worth of authority and at this point this year it's almost $250 million.

There appear to be a couple of critical components to having the program widely used in an area. First is seminars developed and education provided by State banking associations and the local farm representatives; and the second appears to be strong interest on the part of the congressional delegation to go home and tell people how the program works and what it's meant to do.

EXTENSION OF NET WORTH CERTIFICATE PROGRAM

The CHAIRMAN. As you know, the Net Worth Certificate Program expires on April 15. You've been somewhat critical of the program. Will the administration support an extension of the authority for the net worth certificates?

Mr. SETHNESS. We will continue the past support for the extension of the Net Worth Certificate Program for the thrifts, yes.

The CHAIRMAN. Does that mean you would not support an extension expanding that would include agricultural banks?

Mr. SETHNESS. We are not at all enthusiastic about that idea. I think there are some significant differences between the thrift and the agricultural banking situations. The thrift problem, at the time the Net Worth Certificate Program was set up, was an asset-liability mismatch driven largely by interest rate changes. It was because of this single exogenous variable, which everybody expected to improve dramatically over the near term, that additional time was bought for the thrifts through that fashion.

I think granting the agricultural banking system a program like this involves other difficulties. It would be administratively complex and require some people and resources that the FDIC does not have the budget for. Also, to get it targeted properly to banks that one can expect to survive requires some very difficult judgment

calls by someone. It also creates the situation where the FDIC reserves are reduced to the extent that loan losses are created against the certificates that are issued. It may also reduce FDIC's income and create a budget outlay if the notes that the FDIC transfers for the net worth certificates are interest-bearing.

In any case, there are a number of reasons why we prefer not to see it extended to other types of lenders.

The CHAIRMAN. In the FDIC's report they conclude the following: "Should Congress decide to proceed with a relief program, it is the FDIC's view the best option is a Loan Loss Deferral Program." You have heard several of my colleagues, both on and off the committee, who support that concept. Obviously, we don't know the exact details of what that will look like yet, but in principle, what is the administration's position on the Loan Loss Deferral Program?

Mr. SETHNESS. Principally, the administration is worried about departures from generally accepted accounting principles [GAAP] that cloud the picture of what capital is actually in place in the banks. The loan loss amortization provision obviously does create those distortions of GAAP accounts.

The CHAIRMAN. Well, we're all worried about a lot of things. I just want to know, are you for it or against it? I wish the whole situation didn't exist. I've got worries about lots of things we do around here but we have to be pragmatic. We've got a problem. Are you for or against the program? I can outline my problems. I wish we weren't having to consider it, but we are. That's the real world. So are you for or against what the FDIC says?

Mr. SETHNESS. I am for the regulators working out a reasonable approach to capital forbearance. I've seen at least one proposal developed by the Office of the Comptroller of the Currency that I prefer to loan loss amortization as a means of getting at capital forbearance. I think that it is within the current authorities of the regulators to work out the most effective approach.

The CHAIRMAN. Well, it may be, but there's going to be a bill. So when the bill comes out, you'd better take a look at it and let us know what you think about it because it's going to go.

Senator Dixon.

Senator DIXON. Mr. Chairman, I thank Mr. Sethness for his valuable testimony. I think I will forego questions because I am anxious to develop the rationale concerning these bills with the next panel of witnesses. But I thank Mr. Sethness for his time.

Mr. SETHNESS. Thank you, Mr. Dixon.

The CHAIRMAN. Senator Gorton.

Senator GORTON. If we should pursue any one or more or several of these proposals, what contribution should bank owners sacrifice who are making gains under any of these bills in the form of their own equity?

As I remember, the most famous of our bank bailouts in recent years has been Continental Illinois. If I remember correctly, Continental Illinois owners sacrificed, for all practical purposes, all of their equity.

Would you have as a condition of any of these proposals, whether you approved of them or not, a real contribution on the part of the bank owners of that sort?

Mr. SETHNESS. I think it would be entirely appropriate to have some disincentives to rushing into the utilization of the program. I know the FDIC has suggested some ideas and certainly will report to the committee the kinds of things they might think about imposing on owners and banks. Some of those are worth thinking about hard.

Senator GORTON. But you don't have a formal position of specifics in that respect?

Mr. SETHNESS. I do not.

Senator GORTON. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dodd.

Senator DODD. Yes, just very briefly. Mr. Chairman, you raised the question about that secondary market for agricultural mortgages. I just really have one question in a sense to you, but depending on how much you know about it, you certainly are aware that last year the Farm Credit Administration came under a lot of heat from Congress and from public criticism I might say as well. There was a House report that accompanied legislation that was introduced citing the lack of effective regulation, oversight, certain problematical economic trends and the like.

OVERSIGHT BOARD FOR FHA

At any rate, in turn, it required that Congress enact that piece of legislation, that in addition to a number of other things, calls for the appointment of a new full-time three-member Board to oversee the agency.

What can you tell us about that Board in terms of the administration's nominees, what they're likely to do, who's likely to be on it, what sort of things they're thinking about there?

Mr. SETHNESS. My understanding is that members of that Board are expected to be named shortly. I'm not completely comfortable in giving you a definite time because that that's been true for a number of weeks now.

Senator DODD. Have you had a chance to interview any of those people at all?

Mr. SETHNESS. I have talked to a fairly large number of people that have come through who were candidates for those jobs. The common characteristics we were hoping to find were financial skills, management capabilities, and a degree of intelligence that would allow them to get up to speed on a complicated problem very quickly.

Senator DODD. When can we expect to receive the names of the nominess to that Board?

Mr. SETHNESS. I'm not sure. I hope that it's very soon.

Senator DODD. A month?

Mr. SETHNESS. As I meant to say earlier, I've been hearing that we ought to be able to see those names next week for a couple of weeks now. Soon. Sooner than 1 month.

Senator DODD. All right. It sounds like this place.

How about any discussions with the Department of Agriculture? Are they being involved in this at all in terms of the kinds of people on that board, do you know?

Mr. SETHNESS. Yes. The Department of Agriculture, the White House Personnel Office, and the Treasury have all been talking to the people who would are candidates.

Senator DODD. But for a couple of weeks you've been told next week?

Mr. SETHNESS. Right.

Senator DODD. Well, I presume I would be expressing the views I guess of most of us here. We would like to see those.

Senator DIXON. Before planting season if possible.

Mr. SETHNESS. I couldn't support that thought more strongly.

Senator DODD. Thank you very much.

The CHAIRMAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman.

Mr. Chairman, just following up on what my good friend and colleague from Connecticut has discussed, Mr. Secretary, I think it's important for you to bring back to the administration and to all those good people who you just mentioned this Senator's views that it is incongruous to be initiating emergency rulemaking and you don't have these three people there who are supposed to be carrying it out.

BOARD APPOINTMENTS ARE PASSED DUE

Statutorially, we said that that was going to be done within 60 days. Now it almost seems to me that rules will be promulgated without having any of their input, you're going to have all this rulemaking and decisionmaking done for them and maybe have three eunichs. You tell them, "Yes, this is what you do," and without their input into the process. Maybe it's what Treasury wants. I don't know.

But when I hear your equivocating responses, Mr. Secretary, to the chairman's question about some other issues regarding the treatment of the writedown over a 10-year period it just seems to me that there's a predisposition to duck this whole issue.

It doesn't make much sense to pass legislation December 23, which requires the appointment of this Board within 60 days and they're not here. And as you've been hearing it day after day, week after week, I think you should bring back to whoever makes these decisions that they should get about the business of the people and implement this legislation.

I think Senator Grassley made some very valid points. We're talking about all these wonderful things that are taking place and that's all we're doing. It's not being translated into the kind of action that can be felt back at home with the various farmers.

Now you might say, "As a Senator from New York, what kind of interest would you have?" We're a rather large agricultural State. Although we may not have been affected quite as severely as some of our other brethren in terms of agriculture, we've got people losing farms under those same circumstances.

Now I voted reluctantly for that Farm Credit Act because, as you know, there was—I won't say a bailout—but a sharing of assets from the stronger banks to those who are in peril. It doesn't, again, make sense to have that legislation and then not have it implemented because we haven't put the three people on there.

So are you going to assure or can you assure this committee that you at least are going to press to see that that's undertaken?

Mr. SETHNESS. I can assure the committee that I will press and that I have been pressing as hard as I could since December 19 and 23 when it was signed. I have been pressing to do the best that we could in terms of getting the best people in there and having regulations that made some sense developed in time to do some good.

Senator D'AMATO. Well, who are the people you have been pressing?

Mr. SETHNESS. The White House Personnel Office.

Senator D'AMATO. God bless you. You're going to need some help. Do they know the right kinds of people? What qualifications are you looking for? Let's go into this. I have seen some turkeys come up here from there.

Mr. SETHNESS. The perfect person would——

Senator D'AMATO. Well, you're not going to get a perfect person, but I hope you get an appropriate person.

Mr. SETHNESS. A senior financial executive with some agricultural or agricultural lending background that has experience in a regulated industry. It would be even better if he had a law degree.

Senator D'AMATO. Are they letting you do this or are they going to make potential candidates pass the litmus test—and I won't get into what that entails, but really——

Mr. SETHNESS. We are trying to find——

Senator D'AMATO. Have you sent them some names?

Mr. SETHNESS. There are a number of names over there of qualified people.

Senator D'AMATO. I mean, what was the origin of these names? Do you know what I'm saying—"I was with so and so in the primary back in such and such a time"—I mean, if we're going through that, it's going to be a joke. We've had some—I won't get into it.

Senator DIXON. I don't know if I'm allowed to listen to this. Am I, Mr. Chairman?

The CHAIRMAN. Cover your ears. [Laughter.]

Senator D'AMATO. He knows about that kind of stuff. He's an expert.

Senator DIXON. He sure does.

Senator D'AMATO. I understand about it, too. I came from a strong political party.

Mr. SETHNESS. I'm a Presidential appointee, Senator. So I can't really comment on appointees.

Senator D'AMATO. There are exceptions to the rule. Some of them are qualified. So press them a little.

Mr. SETHNESS. I will press them a lot.

Senator D'AMATO. Get the Secretary on them. He can do that. He's got a little clout over there. He put in half those people.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator Gorton and I were just suggesting that he and I were glad we came from nonmachine States. [Laughter.]

Next we're happy to have before the committee Mr. Randall A. Killebrew, president, First National Bank, Petersburg, IL; vice chairman of the American Bankers Association's Government Re-

lations Council; accompanied by Michael E. Fitch, vice president for Agribusiness Affairs, Wells Fargo Bank, San Francisco; Chip Backlund, president, Bartonville Bank, Peoria, IL; president of the Independent Bankers Association of America; and Leslie G. Horsager, vice president, Prudential Insurance Co., on behalf of the American Council of Life Insurance.

And it would seem to me that this witness list is being stacked by people from Illinois today, Senator Dixon.

Senator DIXON. Well, Mr. Chairman, it is an excellent panel and I'm delighted to present this fine panel to the committee, particularly Mr. Killebrew and Mr. Backlund who are old and warm friends and they are distinguished members of the banking community in our State.

The CHAIRMAN. Mr. Killebrew, please proceed.

STATEMENT OF RANDALL A. KILLEBREW, PRESIDENT, FIRST NATIONAL BANK, PETERSBURG, IL, VICE CHAIRMAN, AMERICAN BANKERS ASSOCIATION'S GOVERNMENT RELATIONS COUNCIL, ACCOMPANIED BY MICHAEL E. FITCH, VICE PRESIDENT FOR AGRIBUSINESS AFFAIRS, WELLS FARGO BANK, SAN FRANCISCO, CA

Mr. KILLEBREW. Thank you, Mr. Chairman and members of the committee. I am Randall A. Killebrew, president of the First National Bank of Petersburg, IL, located in Menard County. Accompanying me today is Mike Fitch, vice president for Agricultural Business Affairs with the Wells Fargo Bank in San Francisco, CA. We are both pleased to be able to testify on behalf of the American Bankers Association [ABA]. I am this year's vice chairman of the ABA's Government Relations Council, and I also currently chair the ABA–IBAA joint task force on agriculture credit.

Mr. Fitch is currently the ABA's agricultural bankers division chairman.

Agriculture is faced with a situation where they have more debts than the current income levels will support.

In the long run, one of two things has to happen to this debt. It either must be repaid through future profits within the agriculture industry and future profits for borrowers, or it must be destroyed and absorbed by the institutions which hold that debt.

In either case we need time. We need time for the borrowers to regain profitability and have the opportunity to repay the debt, and for that portion of the debt which is not going to be able to be repaid through future profits, we need time for the holders of that debt to absorb it in an orderly manner.

BURDENS ON FARM-RELATED ENTITIES

This debt presents a tremendous burden for a number of entities within our economy, and I would like to look for a moment where that burden falls the heaviest.

First of all, it falls heavily on our communities. We are seeing farm equipment dealers, seed and fertilizer dealers, experiencing great problems today dealing with the problems of troubled agriculture. In fact, in small town rural U.S.A., each businessman up and down Main Street is suffering from the plight of agriculture. They

are all seeing the profitability of their businesses shrink at a time that the margins in their businesses are shrinking, and it is a very difficult problem for them to contend with.

It goes farther than to the business community and the farmers. It goes to the very grassroots of our communities, to the schools, the fire districts, the counties and the cities who rely on tax revenues as a source of income. If land values deflate, assessed valuations go down and communities are hard-pressed for tax dollars. And that is happening at the same time Federal revenue sharing and other sources of income to these communities and governmental units is also diminishing.

Certainly, the borrowers are suffering a great deal from this excess debt. Those who are unable to repay or reschedule their indebtedness are going to be forced to go into insolvency. There are fewer and fewer alternatives for the borrower to choose from in refinancing or rescheduling his debt. And some of these people, some of these borrowers are going to be forced out of business and attempt to relocate into a marketplace which is dominated by high technology, and they are going to have very few marketable skills. And that is a very difficult situation for those borrowers.

Certainly, the banks are also suffering as a result of the plight of agriculture. The value of the bank franchise diminishes as the farm economy declines. The bank franchise is no different than the farm equipment dealer or the other merchants that make up the community. They are hard pressed to deal with the problems, and the value of their business is declining.

Many of the larger regional banks in our area are pulling away their support for agriculture, and this makes it more difficult for the smaller banks to serve the agriculture community. Small banks do not have access to national capital markets. Their stock is not traded on an active basis. The really only long-term source of recapitalizing the banking industry is a retention of earnings for that industry.

Ultimately, the burden of this excessive debt in agriculture, so far as the the banks are concerned, if we are not successful in finding some resolution to it, will fall on the FDIC fund, because they will be called upon more and more to bail out and close and restructure banks which are no longer viable.

Farm borrowers must adjust to a new environment. Farming has been changing from a way of life to a business. Farmers must change from inflation managers to business managers. The farm economy is changing from a national economy to a world economy. The environment is changing from one dominated by short-term policies to one emphasizing long-term policies. Farming is changing from an industry depending upon Government assistance to, hopefully, one that is emphasizing self-assistance. Growth goals must be replaced with profit goals. But as we go through this transition, we must find ways to stabilize the farm borrower and help him meet his problems during this very difficult transition time.

We need to help restructure his loans, so he can meet his debt service in an orderly manner, by helping him learn new management techniques and skills and by giving him time to allow agriculture to return to a more profitable state.

AMORTIZATION OF LOAN LOSSES

We also must find ways to help banks stabilize their capital during this transition period, by providing temporary relief from regulatory capital standards, and certainly, the amortization of loan losses over time is the quickest and simplest way that that can be achieved. It allows banks to earn their way through these losses and encourages banks to work with their customers and develop workable solutions. We must also provide better ways to handle insolvent banks when that time comes, so that it is less disruptive to the community than the current means that are being used.

We also must find ways to stabilize land values. We desperately need to develop a secondary market which will provide farm borrowers access to the institutional investor market. We cannot leave the farm community with only one source of long-term credit, that being the Farm Credit System. That is not healthy for the farm community, it's not healthy in any situation to see it dominated by one lender.

We must think of allowing banks to take equity interest in real estate as partial payment of debt to keep that land off the market, and by extending the holding period for banks to carry land acquired through forfeiture or foreclosure.

Ultimately agriculture will receive the financing it needs. The question really is, will the commercial banking system continue to play a major role in that financing? The reorganized Farm Credit System with a line of credit from the U.S. Treasury will once again be a formidable competitor in the competition for agriculture credit. The Farmers Home Administration will continue to be a major supplier of agriculture credit.

Without your assistance, we will see agriculture change from an industry of many small producers, financed by a variety of sources to an industry dominated by a number of large producers, financed primarily by quasi-governmental agencies. This would not be in the best interest of the rural communities, of the individuals or the institutions which make up those communities.

Thank you.

[The complete prepared statement follows:]

A Moratorium on Foreclosures. Some have suggested placing a moratorium on foreclosure proceedings against farmers who fail to keep up their debt service payments. This approach ends up hurting both farmers and lenders.

First, a moratorium would have a chilling effect on future farm lending, especially for young or marginal borrowers.

Second, a moratorium would not improve a farmer's cash flow or help him or her to obtain additional credit for continuing operations. It just buys some time, perhaps at the cost of some further erosion of the farmer's capital. If farmers are facing foreclosure, they are experiencing more than temporary difficulties. For the last few years, bank regulators have encouraged forbearance on farm loans so that banks will resort to foreclosure only when no mutually satisfactory plan to make the loans payable can be worked out.

Third, a moratorium would overwhelm many farm banks. Farmers would have less incentive to keep their loans current. The banks could not liquidate any of their nonperforming loans; they would be locked into continuing losses from the interest carrying costs.

Relaxing State Laws to Maintain Rural Credit. Some restrictive state laws -- pertaining to farm ownership, unit banking, and out-of-state acquisitions -- exacerbate current problems. Restraints on farm ownership reduce the demand for, and hence the price of, farm land. Unit banking states limit the ability of banks to weather losses through offsetting profits from a more diversified lending base. Moreover, states that still require acquirers of failing banks to run the banks as stand-alone operations make it hard or impossible for the FDIC to arrange purchases that could maintain banking service for many communities. Neither our rural citizens nor the FDIC can continue to afford barriers to branching in emergency situations.

Similarly, the emergency acquisition provisions of the Garn-St Germain Act of 1982 severely restrict acquisitions of troubled banks across state lines: The bank must have failed, and must have assets of at least $500 million. This is "populism" for a few bankers -- but not for farmers, not for people in small towns, and not for the other bankers who must finance the FDIC. The emergency acquisition provisions will expire on April 15 unless the Congress extends them. If we want to manage the failure of small banks better -- so borrowers and small savers are helped -- Congress should eliminate these restrictions and extend the emergency provisions.

Conclusion

Agricultural bankers deserve our respect for their able handling of the challenges caused by the massive structural changes now taking place in the agricultural sector. But we must be careful about taking "crisis" actions that will cost us dearly over time without really helping most farmers or bankers.

We will seek full utilization of existing programs that give temporary aid to basically sound farmers and farm bankers who are encountering short-term problems. These supports are not insignificant. The Farm Credit System has just chartered its new Capital Corporation in order to channel System reserves where needed most. The Farmers Home Administration has already begun to put in place its new $490 million interest rate buydown program, and its other lending programs can continue to help both farmers and bankers.

We also will continue to work with the bank regulators to consider the best means possible to ease the plight of farmers and bankers during this exceedingly difficult transition period. We must recognize, however, that regulators also have a long-term duty to ensure that banks are soundly run and capitalized, so as to protect borrowers, lenders, and the deposit insurance funds.

The new special assistance programs that have been proposed are, for the most part, problematical in many respects. There is no panacea. In varying degrees, the proposals: (1) run the risk of actually weakening the banking industry over time; (2) will likely be very expensive, either now or in the future; and (3) pose serious questions of equity as between lenders to various sectors of the economy.

We recognize the seriousness of the agricultural bank problem to important areas of the nation. We will keep at it. We will consider carefully all proposals to assist agricultural banks and will continue to work with the Office of the Comptroller, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Department of Agriculture to develop approaches essential to the long-term well-being of the agriculture credit sector.

Mr. Chairman, that concludes my prepared statement. I would be happy to answer any questions the Committee may have.

STATEMENT OF THE

AMERICAN BANKERS ASSOCIATION

ON THE

PROBLEMS OF AGRICULTURAL CREDIT

PRESENTED TO

THE COMMITTEE ON BANKING, HOUSING AND

URBAN DEVELOPMENT

UNITED STATES SENATE

BY

RANDALL A. KILLEBREW

MICHAEL E. FITCH

MARCH 6, 1986

Mr. Chairman and Members of the Committee:

I am Randall A. Killebrew, President of First National Bank in Petersburg, located in Menard County, Illinois. Accompanying me today is Michael E. Fitch, vice president for agribusiness affairs with Wells Fargo Bank of San Francisco, California. We are both pleased to be able to testify today on behalf of the American Bankers Association. I am this year's vice chairman of the ABA's Government Relations Council, and I also recently chaired the ABA-IBAA Joint Task Force on Agricultural Credit. Mr. Fitch is the chairman of ABA's Agricultural Bankers Division.

Let me briefly tell you about my home town and how it has been economically impacted by the problems confronted by American agriculture. The incorporated town of Petersburg, which is in west central Illinois north of Springfield, consists of less than 2,400 people, and my home county, Menard, includes an estimated 10,000. Petersburg has one branch of an out-of-town savings and loan and serves as home for two independent banks. First National Bank has $43 million in assets, and approximately 35 percent of its loan portfolio is in direct farm production loans.

My home town and county are in better shape economically than many of the troubled communities of the Midwest and other predominantly agricultural areas, partly because of better-than-average production. Good productivity in the past has helped local farmers overcome the difficulties of the last few years. However, there has been increasing concern on the part of farmers and businessmen alike in my county about being caught up in the same kind of problems as the communities to the west of us.

Mike Fitch represents the second largest agricultural lender in the nation, Wells Fargo. Their West Coast farm borrowers are facing the same cost price squeeze that is affecting the Midwest and other heavily agriculture-dependent areas. At Wells Fargo, the agriculture portfolio has traditionally outperformed other loans. For the last two years, agricultural loans have not performed nearly as well as the rest of Wells Fargo's portfolio because the farmers are not doing well. According to the Federal Reserve Bank of Chicago, California banks charged off more than twice as high a percentage of their agricultural loans outstanding in 1984 than banks in any other state.

Mr. Chairman, we appreciate the opportunity to address the problems of commercial banks involved in agriculture. The performance of the farm economy impacts more banks than many people realize. Of some 14,000 commercial banks, we estimate that more than 6,000 banks are substantially involved in agricultural lending (more than 10% of their portfolios). In addition, commercial banks hold $47 billion

The CHAIRMAN. Thank you, Mr. Killebrew. Mr. Backlund.

Senator DIXON. Mr. Chairman, may I just interrupt to inquire. I appreciate the fact that Mr. Killebrew did not read his entire 10-page statement, but it is a very good one with a lot of important subject matter in it, and I presume the Chair will see to it that that is reproduced in the record.

The CHAIRMAN. Mr. Backlund, excuse me for just a moment. It is my understanding, Mr. Fitch was here as a backup and not to testify, but I saw you reach for the microphone. So before I continue on, I want to know, if that was just a reflex or you wanted to say something.

Mr. FITCH. If I may, Mr. Chairman, members of the committee, I would like to just make a couple of additional comments.

I was highly involved in the preparation of that testimony and the whole consensus approach that we have had with the IBAA. But I did want to say as a representative of Wells Fargo Bank in California, notwithstanding the fact that we, indeed, are the second largest commercial bank lending to agriculture in the Nation, I would like to underscore the fact that in the Western United States, the borrowers, farm borrowers, as well as their lenders, are experiencing exactly the same pressures that we are experiencing throughout the farm community and the agricultural banking community throughout the Nation.

I would also like to say that because I am active in a family livestock-timber partnership in northern California, it is particularly gratifying to me in my capacity as chairman of the American Bankers Association agricultural division, to note the forbearance and the commitment that commercial banks have had to serving agriculture. We are convinced that over time agriculture, as our most vital industry, will, indeed, be good business, but we are asking for some interim assistance, while this industry turns around.

I would like to underscore that, as an industry, the American Bankers Association has seen fit to commit substantial financial resources to a major research project that we hope will be released in June that is going to study the dramatic structural changes taken place in agriculture, this whole new environment we have because we are international, combine that with the dramatic changes in the banking industry and come up with specific legislative and regulatory proposals that make sense over the long term.

In the interim, nonetheless, we recognize that there are some borrowers and some banks that, indeed, are in need of short-term assistance, and that is why we appear before you today.

I would be remiss, if I did not make one final comment in relation to Secretary Sethness' testimony, in which he outlined the reasons why commercial banks should not receive the same type of assistance as the Farm Credit System. I would like to underscore that our approach in our proposal emphasizes that any assistance should be targeted to the ultimate farm borrower, not the institution. And the reason for that is not only in terms of fairness, but I think more importantly, to avoid in today's deregulated banking environment, stockholder pressure, that would say to bank managements, if you cannot avail yourselves of the same type of assist-

ance for your farm borrowers as other institutions, perhaps you don't belong in the business.

I see some dramatic danger there. For example, in California, whereby 80 percent of commerical banking agriculture credit is advanced by five major banks, and clearly, that type of magnitude of farm credit cannot be absorbed by either the Farm Credit System or any other individual institution.

There are many other things I would hope to say, but much has already been said, and I look forward instead to your questions.

Thank you.

The CHAIRMAN. Mr. Backlund, we are happy to have you before the committee again.

STATEMENT OF B.F. "CHIP" BACKLUND, PRESIDENT, BARTONVILLE BANK, PEORIA, IL, PRESIDENT, INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Mr. BACKLUND. Thank you, Senator.

As you know, I am president of the Independent Bankers Association, which has 7,400 community bank members, half of which are agricultural banks. I am also president of the Bartonville Bank, which is 60 miles north of Petersburg in Illinois. Also I am connected with a group of six small banks, where approximately 80 percent of our loans are agriculture-related loans in small communities.

We appreciate your holding these hearings to review these proposals to stop the hemorrhaging out there that is going on among these smaller agricultural banks. Many of these banks have been well capitalized in the past, but are losing capital very fast. Their capital ratios are going down and the figures the FDIC presented a few weeks ago to you actually did not include all the chargeoffs in 1985.

The Federal Reserve has estimated that there will be $1.2 billion losses in 1985, which is 3 percent of total agricultural loans.

$2.7 BILLION CHARGED OFF IN 1985

I do want to point out that with the Farm Credit System amendments, which were put into place last December for the Farm Credit System, that you did respond to similar problems that they were having. With that legislation in place, the Farm Credit System was able to charge off almost $2.7 billion in loan losses during 1985 without incurring significant deterioration of their banks' lending capacity or impairing their access to the capital markets, which, of course, is extremely important to them.

Commercial banks and their farm borrowers simply must be provided with a program for the stabilization of capital comparable to what was done for the Farm Credit System. Such a system is needed now. It was needed yesterday, last month, last fall. And I submit, Mr. Chairman, it should be done in the next 15 days, because this is the critical time for restructuring and taking care of the farm customers for this year's operating loans.

Because of this critical time factor, we much prefer—as much as we appreciate Senator Dole's comments, we much prefer the regulators to take the initiation and deal with the problem by adjusting

their regulatory policies. However, we are prepared to help in pursuing legislation, if they do not take that action. But we've had lengthy discussions over the last months with bankers, bank regulators and farm groups, and it seems clear that three things need to be implemented in any capital stabilization program.

First, an agricultural bank should be able to maintain its full, individual loan-lending limit, in order to preserve its earnings potential. Such a bank's limit on the size of an individual loan is directly related to its capitalization.

STABILIZE BANK CAPITAL

The bank's capital structure must be temporarily stabilized, in order to meet the capital needs of larger, generally stronger farm borrowers. If loan chargeoffs precipitously reduce a bank's capital and its ability to finance its stronger farm customers, the bank risks losing their borrowers, those borrowers and permanently impairing the institution's ability to rebuild earnings from a strong customer base; a very important point. That is, I think, why bankers, as a whole, so overwhelmingly prefer this loan amortization proposal.

Second, adjustments in regulatory policy need to address not only exceptionally well-capitalized agricultural banks, but also those banks without a capital stabilization program which slip below the 6-percent standard, but who have reasonably good prospects for recovery over time.

There are several hundred agricultural banks in this latter category, whose capacity to hold on to their stronger customers and retain their earnings, and turnaround potential is dependent on having some means of preserving their capital.

Third, in implementing a capitalization program, explicit adjustments need to be made in regulatory policy, which go beyond the rhetoric that capital forbearance should be practiced by examiners on an ad hoc basis. Those adjustments should spell out revised regulatory standards that will be applicable on a standard, consistent basis to all agricultural banks. We are encouraged that both the Comptroller and the FDIC, in their comments to you, considered specific policy options that could be adopted to preserve capital and banks with a troubled farm loan portfolio.

In view of the extreme urgency to raise the confidence and capacity of agricultural bankers for dealing with farm financing this year, the IBAA joined the American Bankers Association in January, creating a joint task force on agricultural credit. The recommendations of that task force have been passed on to you, and they are made part of my statement here.

In that joint statement, the first priority of the banking industry to temporarily stabilize bank regulatory capital is a change in regulatory policy permitting the amortization of loan losses over a multiyear period. A major attraction of amortization is that it will enable a bank to maintain its earning potential by preserving the bank's capital for purposes of maintaining the size limit on individual loans.

Bankers, as I said, overwhelmingly prefer this option, a most important point. Another most important point is that it would result

in no Treasury cost. In addition, allowing banks to amortize certain farm loan losses could reduce ultimate draws on the FDIC fund resulting from this problem by enabling banks to hold their stronger farm customers and thus keep their earning potential from deteriorating.

So we recommend this loan amortization policy as an effective way to stabilize bank capital temporarily and accomplish the desired objectives. We are not wedded to that option, however, and if there was another way to preserve the bank's full capacity to finance their customers, to do so through regulatory policy that is available on a consistent basis to all banks with agricultural loans, we would certainly work with you on that.

We do not presume that whatever regulatory adjustments are made necessarily apply only to agricultural debt. A somewhat broader coverage would better enable the regulators to act. In light of what has already been done by the Farm Credit System, and the fact that over 1,700 commercial banks have more than 50 percent of their total loans committed to production agriculture—and that doesn't include agribusiness loans—there is ample justification for putting in place a capital stabilization policy for only the agricultural sector during the critical spring financing period.

ABILITY TO ENHANCE A STRONGER CUSTOMER BASE

The question was raised whether these proposals might encourage unsound banking practice. The truth is that it will enhance the banks' ability to hold on to a stronger customer base, which is necessary for earnings recovery.

Banks are now firmly committed to the principle that borrowers must be able to cash-flow their debt out of current earnings. And farmers generally are postponing capital purchases, unless those purchases are directly related to the bottom line. However, given the present environment, it is often difficult to reach the collateral behind accumulated farm debt, even if liquidation is called for.

Given the currently depressed markets for farm assets, liquidations cannot be practiced in every case where liquidation is normally indicated. Therefore, bankers' management options are limited. Under these circumstances, an adjustment in regulatory policy is certainly a safe and sound course of action.

In the long term, we share the concern that greater assets and earning diversification for agricultural lending is needed, and one very promising avenue which has been mentioned here today is the secondary market for longer term farm loans originated by commercial banks.

I do agree somewhat with Secretary Sethness, in that I think he is correct that it will probably be necessary to have Government support, at least initially, for this secondary market.

Finally, I want to emphasize again the very compelling need for action to be taken now during the heavy lending season in agriculture. This is critical, not only for the lenders and their stronger borrowers, but for the farmers who are seeking 1986 financing. The ability of the farmers to secure financing is dependent upon the strength and capacity of financial institutions that supply the

in agricultural debt. The agricultural economy contributes over one-fifth of the U.S. GNP considering both the direct and indirect impact of the industry. Agriculture has been a significant creator of new real wealth year after year and it is a major contributor to our national balance of trade.

Concern about the deteriorating agricultural economy and its impact on banks, their borrowers and their communities led the American Bankers Association and the Independent Bankers Association of America to establish a special ABA-IBAA Task Force on Agricultural Credit. The 12 member Task Force includes representatives from a broad cross-section of the agricultural banking industry.

The Task Force has recommended a plan of action involving three main elements: (1) stabilization of bank capital, (2) stabilization of agricultural borrowers, and (3) stabilization of farm real estate values. Some aspects of this plan of action, particularly policies designed to stabilize bank capital, can be undertaken by the bank regulatory agencies. Other aspects require legislation.

The Task Force was formed because American agriculture is undergoing massive change that threatens both banks and their farm borrowers if they are not given time to adjust. Let me briefly discuss the problems of agriculture and the banks that lend to farmers.

The agricultural sector of our economy is undergoing a period of massive strain and adjustment. Farm business failures and farm lender closings during 1985 occurred at a rate not seen since the Great Depression.

The current conditions in the agricultural sector are a by-product of the booming decade of the 1970s. During the 1970s, domestic and foreign farm sales grew sharply, increasing farm revenues at an annual rate of 10.1 percent. Much of this growth was fueled by exports which increased from just $7.0 billion in 1970 to $41.0 billion in 1980--an annual rate of almost 20%. By 1980, exports made up 30% of total farm sales compared to less than 15% in 1970. Thus, the growth in income that occurred through much of the decade was highly dependent on the farmers' ability to preserve or increase their share of exports.

There was a widespread belief--by government and private analysts--that foreign demand for our agricultural products would continue to grow at a much higher rate than we would be able to supply. This perception arose from the belief that low income nations would find it difficult to provide their population with food. Thus, U.S. farmers would have an unlimited market for their products.

However, the increased demand and slowly adjusting supply

that made the decade a good one were short-term aberrations from the long-term trend. The trend for most of the 20th Century has been declining real prices for food products. In the current cycle, the trend has been restored. Prices dropped as supply far outstripped demand worldwide.

The result of this sudden and massive change in world markets was an equally sudden drop in farm income and increase in agricultural credit problems.

Farm debt is concentrated among less than 20 percent of the 2.2 million farmers in the U.S. Approximately 17 percent of all farmers are highly leveraged, with debt to asset ratios of over 40 percent. However, these farmers with debt to asset ratios in excess of 40 percent owe approximately 46 percent of the total farm debt. Given this high concentration of the farm debt and the unprecedented (post WWII) four year decline in land prices, we can expect unprecedented rates of farm failures in the absence of corrective policy actions to assist banks as they work with their farm borrowers.

As the agricultural economy goes through a period of adjustment, so are lenders to this key area of our economy.

Commercial banks hold a large portion of the agricultural debt. The Federal Reserve Board estimated that during 1985 commercial banks held $47 billion or 22 percent of the total. A large portion of this farm debt (80 percent) held by commercial banks is in the form of non-real estate debt for farm production loans. The commercial banking sector is the largest lender for farm production purposes.

These banks that lend to agriculture are under great stress. The 120 commercial bank failures in 1985 almost equaled the combined failures in 1983 and 1984, and the number of failures during the year was the most since the Great Depression. A recent report issued by the Federal Deposit Insurance Corporation concluded: "Agricultural bank failures took a sudden upturn during the second half of 1985. During the past 14 months farm banks accounted for just over 50 percent of all bank failures. Nonagricultural banks have been failing at about the same pace in 1985 as 1984, meaning that agricultural bank failures almost totally account for 1985's increased failure rate."

Table 1
Bank Failures by Type of Bank

	1982	1983	1984	1985
Agricultural banks	7	7	25	62
Other banks	27	38	53	56
Savings banks	8	3	1	2
Total	42	48	79	120

The increased incidence of agricultural bank failures reflects the problems faced by the agricultural economy and parallels the growing amount of farm loan losses charged off by agricultural banks. Farm production loan losses charged off by insured commercial banks totalled $900 million in 1984, up from $436 million the year before. In the first three quarters of 1985, charge offs came to $755 million. If this trend continues, it is estimated that the total of such charge offs at commercial banks may come close to $1.5 billion for the full year of 1985.

The adjustment process in agriculture has weakened some farmers and contributed to the deterioration of agricultural banks. This certainly does not mean that large loan charge-offs and lower profitability at agricultural banks threaten the safety and soundness of the financial system. But the spiral of farm foreclosures and bank failures are harming not farmers and bankers alone, but also the communities they serve. These farmers and banks and their surrounding communities can be expected to survive, but only if they are given more time to adjust to the massive changes now going on in agriculture.

Mr. Chairman, the ABA-IBAA Joint Task Force developed recommendations addressing three major aspects of the agricultural credit problem facing commercial banks and their borrowers: (a) bank capital, (b) borrowers' financial conditions, and (c) farm real estate values. These are the key areas that we believe must be addressed. However, we do not believe that we have identified the only means to address the problems in these areas. We are making proposals, but we are also willing to listen to any others. We want to work with this committee, the bank regulators, and any others to develop solutions to a very serious problem that is worsening.

I. Stabilization of Bank Capital

Stabilizing bank capital is important because bankers cannot work with their farm borrowers to provide new credit for planting, restructure existing debt, or work out other solutions if the banks are in imminent danger of facing regulatory action because their capital level dropped below 6 percent. As stated earlier, the sudden change in the agricultural economy is resulting in great increases in agricultural loan charge-offs. Banks need time to absorb these losses so they can continue to work with their borrowers and remain of service to their communities. Sticking blindly to a rigid rule on capital will not serve the public well in agricultural communities that need banking services.

Bank capital requirements are an important regulatory tool. In particular, they provide a buffer that helps protect deposit insurance fund reserves. In deciding the proper level of required capital for any bank, regulators must delicately balance these tradeoffs. Sometimes the level of capital to be striven for over the long run should be examined and adjusted due to circumstances. For agricultural banks, we believe now is such a time.

To keep agricultural banks open and to maintain their capacity to extend credit to borrowers, we recommend that special measures be implemented to stabilize the capital structure of agricultural banks. Agricultural banks traditionally have been well capitalized. However, the persistent downturn in the farm economy since 1981 has been severely pressuring the capital structure of hundreds of agricultural banks. Given time, the agriculture economy will recover, providing a basis for greater earnings and replenishment of the capital structure of agricultural banks.

In the meantime, we need measures to prevent prudently managed banks' capital from being precipitously eroded with the resulting regulatory actions and, possibly, large numbers of closed banks. Our propsals are not the only possibilities. We will discuss any serious proposal designed to address the problem of stress on banks' capital levels.

A. Amortization of Loan Losses

This proposal, which would permit banks to write-off loans over a period of years, is one of the recommendations, Mr. Chairman, that you asked federal regulators to consider as an option for aiding banks affected by the deteriorating agricultural economy.

The amortization plan would enable banks to cover their agricultural losses over time through internally generated earnings. Under current federal policies, banks must immediately charge the full value of a loan that is considered a "loss" against its loan-loss reserves.

The primary argument for allowing lenders to take their losses over time is based on the recognition that the farm economy is undergoing dramatic change and that borrowers and lenders all need time to adjust to new conditions. Since the agriculture sector will again be profitable, not allowing lenders to spread their losses over time is justifiable. It would allow the whole agriculture economy to adjust without further accelerating the economic disruption now occurring in rural, agriculturally-based communities.

B. Capital Infusion

The continued deterioration of agricultural banks' loan portfolios has resulted in significantly increased net loan losses. Before the recent stressful years in agriculture, agricultural banks performed better than other banks. As farm sector stress grew, net loan losses of agricultural banks outpaced the loan loss experience of nonagricultural banks.

Capital infusion is another recommendation that would aid banks with problems in their agricultural loan portfolio. Under such a program, the FDIC could inject capital into those banks that have been adversely affected by the current economic situation, but are still judged to be prudently managed.

C. Capital Certificates

Mr. Chairman, a third option we have discussed as a means to achieve capital stability is to authorize agricultural banks to use capital certificates. Certainly, from a public policy viewpoint, banks who extend agricultural credit to their farm customers are not materially different from those lending institutions which provide mortgage credit to American home buyers. Both agriculture and housing are areas where as a matter of national policy, banks were encouraged by Congress to lend. Thus, as a matter of equity between rural America, with the majority of agricultural loans, and urban America, with most housing loans, there is some justification for amending Title II of the "Garn-St Germain Depository Institutions Act of 1982" to include insured agricultural banks.

However, we have a view that the use of net worth certificates by thrift institutions has not been well received by the accounting profession and has tended to cause confusion in the investment community. Therefore, it is our strong recommendation that a capital certificate be instituted only as an adjunct to a more straightforward temporary capital stabilization program administered through the bank regulatory agencies with primary emphasis placed either on capital forbearance or loan amortization. If Congress decides to extend Title II beyond its April 15, 1986 expiration date, we support an amendment requiring all insured depository institutions to achieve the same ranges of capital over a reasonable implementation period.

D. Tax issues affecting agricultural banks

Under the current Internal Revenue Code, banks that experience a net operating loss may deduct that loss against income from their prior ten years of operation, and,

if necessary, from their next five years. The House passed tax bill (H.R. 3838) would limit banks' ability to carry losses back to three years with fifteen years to carry them forward. For banks that experienced losses and had no income in earlier years, this change would be beneficial. Many banks, however, particularly in the Farm Belt, had income in earlier years but currently are experiencing heavy losses. The provision in present law allowing banks to look back ten years was designed to help cushion banks in this position. It does protect the safety and soundness of the banking system.

II. Stabilization of Agricultural Borrowers

The massive reversal of agricultural fundamentals--a return to a less inflationary environment, structural changes in financial markets, and U.S. integration into a world market for food and fiber--require extraordinary cooperation on the part of lenders, borrowers, and others. The banking industry is deeply concerned about the economic problems facing the American farmer. Bankers work closely with farm families in the management of their financial affairs and are quite aware of the financial difficulties many farmers are facing today. Many agriculture-related businesses, which provide products and services to farm families in rural America, are also suffering as a result of the financial problems of farmers. We believe the best approach for assisting these customers is for banks to work in partnership with regulators, customers and others to arrive at acceptable solutions within the existing laws and system. Forbearance and cooperation, until the farm economy improves, are the key to overcoming this economic crisis.

Mr. Chairman, we recognize the budget constraints within which the Congress is now working. Therefore, since the Farmers Home Administration loan guarantee programs are the least costly means of stabilizing, restructuring, and extending agricultural debt, we recommend expansion of the guarantee program. In particular, we recommend changing the manner in which guarantees are scored for budget purposes. They should not be scored dollar for dollar, since they are not direct outlays. In addition, expansion of the $490 million interest rate buydown program included in the 1985 Farm Bill would provide much cashflow assistance to agricultural borrowers at minimal direct cost.

The continuing high inflation-adjusted levels of interest rates and low commodity prices are, of course, at the heart of the present economic difficulties. Banks already have engaged in loan renegotiation, interest-only payment plans, extension of loan maturities, and even significant rate reductions to assist struggling small business and farm borrowers through the current difficult period. We shall continue to do so. Federal assistance in

the form of Farmers Home Administration guarantees or interest rate buydown programs enable more of us to help more borrowers. We believe this to be a very positive approach to helping those farmers who still have viable operations but who are caught up in the current financial crisis.

III. Stabilization of Farm Real Estate Values

Mr. Chairman, as mentioned earlier, the value of farm sector assets has retreated since peaking in the early 1980s. The most pronounced decline has been in land values, which nationwide are off 19% since 1981. The extent of the decline varies widely among states, with the sharpest declines occurring in the western Corn Belt and the southern Plains states. Land value declines since the 1981 peak range from nearly 20% in Michigan to more than 45% in Iowa.

Our Association is interested in exploring possible solutions to the major problems of declining land values. An immediate action that would help reduce the downward pressure on farm land values would be changes in the requirements that banks divest themselves of agricultural real estate within a short period of time (five years for national banks, with an additional five years with Comptroller approval).

Dumping that land on a declining agricultural real estate market merely further deflates the asset values to which all of the lending in rural communities is tied. As a short-term measure, permitting banks to hold that agricultural land somewhat longer would definitely help stabilize farm real estate values.

Our Association recommends that the current limit of five years (with an additional five years if the Comptroller approves) be extended to ten years with an additional five years discretion for the Comptroller for national banks. States should be urged to make similar changes for state banks to prevent further dramatic declines in the value of farm land.

Since structural changes are taking place in the agricultural sector, we believe that thousands of acres of farmland will not be used for farming purposes any more. Thus, banks also should be allowed to purchase farm real estate not only for redevelopment purpose but also to help in the economic adjustment process of both banks and borrowers.

Due to the current agricultural situation, a farmer's long-term financing options and resources for creating positive cashflows are extremely limited. Agricultural banks are exploring options for other sources of long-term

credit, beyond traditional sources, which could provide competitive and stable funds for American farmers.

The acquisition of funds is an ongoing serious concern of the country agricultural banks. During periods when interest rates are high, the small and medium size banks have difficulty in obtaining long-term loanable funds. On a long-term basis, it would be useful to create a true secondary mortgage market for real estate loans so that banks will have the opportunity to tap capital markets.

The ABA proposes the development of a secondary market for farm real estate. Providing banks with a secondary market for agricultural real estate would enable these banks to provide stable and competitive agricultural real estate financing of the farm sector.

According to the Federal Reserve Board's 1985 estimates, the Farm Credit System holds 44.04% of the farm real estate debt, insurance companies hold 11.2%, Farmers Home Administration 8.87% with 26.79% held by individuals and others. Banks only hold 9.01% of the farm real estate debt. Banks cannot lend for long periods of time on farm real estate unless they have either long-term funds or a secondary market.

The development of a secondary market, perhaps with FmHA guarantees, would permit banks to make farm real estate loans, sell them to maintain liquidity, while retaining the servicing and local involvement with their farm borrowers.

This secondary market would enable banks to continue financing farm real estate in periods of reduced bank liquidity because the loans could be sold to investors in this market. For rural banks and their communities, the development of this stable competition with the Farm Credit System, which will also be a source of income for banks, would benefit both farm borrowers and their communities. Increasing competition, spreading the risk of financing farm real estate, and keeping banks as viable lenders all will help stabilize farm real estate values in rural communities.

Through the creation of such institutions as Government National Mortgage Association (GNMA), and the Federal National Mortgage Association (FNMA), Congress has shown its support for encouraging participation in the secondary markets. These government and quasi-government institutions are actively facilitating the needs of the mortgage industry by purchasing mortgages from the originator and reselling them to investors.

Because of these organizations the housing industry has enjoyed the benefit of a highly competitive and efficient credit delivery system. We would urge the government to

play an active role in expanding a pro-competitive environment by developing a secondary market for farm real estate.

Conclusion

It is particularly important that changes be made soon that can help with the current credit and cashflow problems facing farmers and commercial banks in many of our major agricultural regions. We certainly compliment this committee for turning its attention to the credit issue at this time. There should be a sense of urgency associated with the short-term proposals.

The objective of these proposals is to provide those banks and farmers who have the potential of survival with the opportunity to return to profitability. However, given the dramatic rate of adjustment in the agricultural economy occurring at this time, without some programs such as described above, many banks and borrowers with previously successful operations face insolvency.

Mr. Chairman, while we need time now we are also working as an Association to look to the future. We are not simply waiting to see what government can do for us. The ABA has commissioned a comprehensive research report to assess: (1) the major trends in agricultural banking, (2) the future of the agricultural sector, (3) the agricultural credit delivery system, (4) regulatory and legislative actions consistent with these findings, and (5) a strategic planning guide to assist individual banks in their business plans and agricultural lending decisions.

Mr. Chairman, we will continue to explore the above mentioned alternatives with the Congress and the regulators.

funds, and that underlying strength is now being severely tested at this time.

That concludes my statement, Mr. Chairman.

The CHAIRMAN. Thank you very much.

[The complete prepared statement follows:]

T E S T I M O N Y

of

B.F. (Chip) Backlund
President
Bartonville Bank
Peoria, Illinois

and

President
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

Agricultural Debt Issues and Proposals

Before the
Senate Committee on Banking, Housing and Urban Affairs
Honorable Jake Garn, Chairman

Washington, D.C.

March 6, 1986
538 Dirksen Senate Office Bldg.

Mr. Chairman, my name is B.F. Backlund and I am President of the Independent Bankers Association of America (IBAA), a national trade association representing over 7400 community banks. I also serve as president of the Bartonville Bank, a $36 million bank near Peoria, Illinois.

The IBAA appreciates your scheduling these hearings and, requesting the preliminary views of the bank regulatory agencies on proposals to ease the problems being experienced by agricultural banks.

Although many agricultural banks have been very well capitalized in previous years, major farm loan losses are now eroding the capital structure of hundreds of farm banks. FDIC's submission to your Committee on February 18 reported that over 500 agricultural banks had primary capital ratios of less than 8 percent, and another 1450 of those banks had 8-10 percent capital ratios. Furthermore, those figures do not take into consideration the full charge-offs of farm loans in 1985, which the Federal Reserve has estimated (probably conservatively) will exceed $1.2 billion, or 3 percent of such loans that were held by the banks.

With the Farm Credit Act Amendments signed by the President last December 23, Congress and the Administration responded to similar problems being experienced by the Farm Credit banks. The explicit Federal financial backstop provided to the Farm Credit System by that legislation guarantees that the Farm Credit banks will continue to have access to the capital markets at competitively favorable rates. With that legislation in place, Farm Credit was able to charge off almost $2.7 billion of loan losses for 1985 without incurring significant deterioration in the Farm Credit banks' lending capacity or impairing the System's access to the capital markets at favored rates.

Commercial agricultural banks and their farm borrowers must be provided with a program for the stabilization of capital comparable to what was done for the Farm Credit System. Such a program is needed now, within the next fifteen day period which is critical for agricultural banks to work with their farm customers in arranging for this year's operating loans.

Because of this critical time factor, we prefer that the regulatory agencies take the initiative and deal with this problem by adjusting their regulatory policies. However, we are prepared to pursue legislation if the necessary regulatory actions are not taken.

As we have discussed options for easing the farm debt problem with bankers, bank regulators and farm groups, it seems clear that three things need to be included in any specific capital stabilization program that is implemented:

(1) First, an agricultural bank must be able to maintain its full individual loan lending limit, in order to preserve its earnings potential. Since a bank's limit on the size of an individual loan is directly related to its capitalization, the bank's capital structure must be temporarily stabilized in order to preserve its capacity to meet the credit needs of larger, generally stronger farm borrowers. Conversely, if loan charge-offs precipitously deteriorate a bank's capital and its ability to finance its stronger farm customers, the bank risks losing those borrowers and permanently impairing the institution's ability to rebuild earnings from a strong customer base.

(2) Second, adjustments in regulatory policy need to address not only exceptionally well-capitalized agricultural banks, whose capital may drop down near the 6 percent regulatory standard, but also those banks that without a capital stabilization policy would slip below the 6 percent standard but would retain a capital cushion and reasonably good prospects for recovery over time. Based on the figures cited earlier, there are several hundred agricultural banks in this latter category, whose capacity to hold onto their stronger customers and retain their earning and turnaround potential is dependent upon having some means of preserving their capital.

(3) Third, in implementing a capital stabilization program, explicit adjustments need to be made in regulatory policy which go beyond verbal exhortations that capital forbearance should be practiced by examiners on an ad hoc basis. Those adjustments should spell out revised regulatory standards that will be applicable on a consistent basis to agricultural banks. In that regard, we are encouraged that both Comptroller Clarke and the FDIC in their written February 18-19 comments to you considered specific policy options that could be adopted to preserve banks' capital as related to the troubled farm loans held by the banks.

In view of the extreme urgency of getting action to raise the confidence and the capacity of agricultural bankers for dealing with farm financing this year, the Independent Bankers Association of America and the American Bankers Association in January created a joint task force on agricultural credit. The recommendations of that task force, and a joint follow-up letter to the bank regulatory agencies, is attached as a part of my statement.

59-527 O - 86 - 3

As indicated in those joint IBAA/ABA statements, the first priority of the banking industry in order to temporarily stabilize bank regulatory capital is a change in regulatory policy permitting the amortization of agricultural loan losses over a multi-year period. A major attractiveness of loan loss amortization is that it will enable a bank to maintain its earning potential by preserving the bank's capital for purposes of determining the size limit on individual loans. In addition, loan loss amortization focuses on the real problem, namely the troubled loan assets, so that the minimum bank capital standards are not altered except temporarily, as provided by the amortized accounting for loan losses. Bankers prefer this option, and permitting the amortization of loan losses could result in no Treasury cost. In addition, allowing banks to amortize certain farm loan losses could reduce ultimate draws on the FDIC fund resulting from the agricultural debt problem, by enabling banks to hold their stronger farm customers and thus keep their earning potential from deteriorating.

We recommend a loan loss amortization policy as an effective way to stabilize bank capital temporarily and accomplish the desired objectives. However, we are not wedded to that option if there is another way to maintain the banks' lending limits and thus preserve their full capacity to finance their larger customers, including banks that would fall below the 6 percent capital standard, and do so through regulatory policy that is available on a consistent basis to agricultural banks. We do not presume that whatever regulatory adjustments are made need necessarily apply only to agricultural debt, if somewhat broader coverage could better enable the regulators to act. However, expanding beyond agriculture may hinder rather than help to produce results. In light of what has already been done for the Farm Credit System and the fact that there are over 1700 commercial banks with over 50 percent of their total loans committed to production agriculture (not including agribusiness loans), there seems ample justification for putting in place a capital stabilization policy for the agricultural sector during this critical spring financing period.

Although we prefer regulatory action without requiring legislation, we are mindful of the fact that the statutory authority for the thrift net worth certificate program and certain other provisions of the Garn-St Germain Act of 1982 expire on April 15. Unless an adequate regulatory response occurs, we need to work with you to assure that this legislation is not extended without including an effective capital stabilization program for agricultural banks.

The question has been raised whether temporarily greater regulatory flexibility with regard to bank capital as it relates to troubled farm loan assets might encourage unsound banking practices. I don't believe that it will, and as indicated, I think that not providing for short-term capital flexibility runs a serious risk of undermining banks' ability to hold onto their stronger customer base which is necessary for earnings recovery. Agricultural banks as a whole are now firmly committed to the principle that borrowers must be able to cash flow their debt out of current earnings, and farmers presently are not making capital purchases unless those purchases are directly related to the bottom line earnings of their operations. However, under the present circumstances, it is often difficult to reach the collateral behind accumulated farm debt even if liquidation is called for. Given the currently depressed markets for farm assets, liquidations may not be practiced in every case where a liquidation is possible. Therefore, bankers' management options are limited, even through committed to sound lending practices, and under those circumstances an adjustment in

regulatory policy to allow greater short-term flexibility with regard to bank capital related to troubled farm loan charge-offs is a proper course of action.

Furthermore, if an agricultural loan loss amortization program is adopted, this will not disguise problem loans from the regulators, but in fact will facilitate banks' "cleaning up" their balance sheets by going ahead and charging off loans where charge-offs are warranted. That certainly should not contribute to unsound lending practices. Unlike the situation regarding the Farm Credit System, such short-term flexibility would occur with an "arm's length" regulatory system firmly in place. For the Farm Credit System, rigorous regulatory policies must still be implemented, pursuant to the December 1985 legislation.

Over time, we share the concern raised in the bank regulators' February 18-19 written comments to you, that greater asset and earnings diversification for agricultural lenders is needed. One very promising avenue that we are pursuing is the development of a viable and dependable secondary market for longer-term farm loans originated by commercial banks. If secondary marketing institutions can be established for farm mortgages, commercial agricultural banks can originate a much greater volume of real estate mortgages, sell them to secondary investors, and increase the banks' earnings that are derived from loan origination and servicing fees. Therefore, the banks would diversify their earnings, and much of the credit risk on the mortgages would be shifted to other investors.

To the extent that a larger portion of farm real estate credit financing can be securitized through secondary market channels, this could promote overall diversification of credit risks with respect to farm real

estate debt, including some of the market share currently held by the government-underwritten Farm Credit System. However, it will probably be necessary to have government support at least initially to secure the farm mortgages originated by commercial banks and offered for sale through secondary market channels, in order for a secondary market to have an opportunity to become firmly established.

Finally, I want to reiterate the very compelling need for action to be taken now, during the heavy lending season in agriculture, which adjusts regulatory policies so as to enable banks to preserve their capital and their lending capacity. This is critical not only for the lenders and their stronger borrowers, but for farmers generally who are seeking 1986 financing. The ability of farmers to secure financing is dependent upon the strength and capacity of the financial institutions that supply the funds, and that underlying strength is being severely tested at this time. Last December, certain explicit steps were taken to shore up the Farm Credit System's financing capacity, including an explicit Federal backstop for FCS's access to the credit markets on favorable terms. Commercial agricultural bankers are now looking to you and this Committee for our comparable difficulties to be addressed.

This concludes my statement, and I would be pleased to respond to any questions.

RECOMMENDATIONS OF THE ABA-IBAA TASK FORCE ON AGRICULTURAL CREDIT

February 4, 1986

The banking industry considers it essential that steps be taken early in 1986 to assist commercial banks and their agricultural borrowers in coping with the accumulation of problem farm debt. The IBAA and ABA met jointly in Dallas, Texas, on January 15-16 and, based on that meeting, will seek measures that can help to stabilize the capital structure of agricultural banks and to assist individual agricultural borrowers in managing their debt during this critical period. Recognizing that agricultural banking can return to profitability only when the agricultural economy is again profitable, the fundamental premise of these proposed measures is that agriculture is experiencing massive change and bankers and their agricultural borrowers need a reasonable period of time to adapt.

We will seek to implement such measures through regulatory action to the extent that they can be carried out under existing law, and we will seek legislation where existing law is inadequate. Our Associations will pursue a plan of action involving three main elements: (1) stabilization of bank capital; (2) stabilization of agricultural borrowers; and (3) stabilization of farm real estate values.

Stabilization of Bank Capital

The most immediate problem confronting agricultural banks is the impact on bank capital of sudden and massive agricultural loan losses. In 1984, agricultural production loan losses charged off by commercial banks totalled $900 million--an increase from $436 million in 1983. Such charge-offs for the first two quarters of 1985 were $520 million, almost double the $280 million charged off in the first two quarters of 1984.

These extraordinary charge-offs are eroding the capital structure of many agricultural banks as the loan losses are deducted from the banks' available capital. As a bank's capital is reduced, both the total capacity of the bank to extend credit and the size of individual loans that the bank can make are correspondingly reduced. If a bank's capital falls below the minimum required by the regulatory agencies, the bank is subject to enforcement actions which may lead to closure.

"The Farm Credit Act Amendments of 1985" (PL 99-205), signed by the President on December 23, 1985, was Congress' response to a similar problem in the Farm Credit System. Faced with mounting agricultural loan losses, the Farm Credit System requested Federal backing to guarantee its continued access to capital in the credit market. Congress and the Administration responded to the Farm Credit System's request for assistance with PL 99-205.

To keep agricultural banks open and to maintain their capacity to extend credit to borrowers, we recommend that special measures be implemented to preserve the capital structure of agricultural banks. Agricultural banks traditionally have been well capitalized, but the persistent downturn in the farm economy since 1981 is severely pressuring the capital structure of hundreds of agricultural banks. The farm economy will recover in time, providing a basis for greater earnings and replenishment of the capital structure of agricultural banks. In the meantime, we need special measures to prevent banks' capital from being precipitously eroded by

(over)

requirements that banks offset problem farm loan assets whose market value has been reduced.

Our first priority as a means of preserving banks' capital is to change regulatory accounting procedures and enable prudently managed banks to amortize their loan losses over a multi-year period. Such a procedure is relatively simple to administer, would assist a broad segment of banks and their borrowers, and would entail no direct government cost.

Two other options that warrant consideration as ways to assist banks in maintaining adequate capital during this stressed period in agriculture are:

- regulator-assisted injections of capital into certain troubled banks. (For example, a qualifying agricultural bank might acquire additional capital from the Federal Deposit Insurance Corporation in the form of debt or equity.);
- unfunded capital certificates similar to net worth or income capital certificates currently used for certain thrift institutions.

Because of the potential direct impact on bank's capital, we shall also focus careful attention on proposed changes to the Internal Revenue Code. For example, banks can currently carry net operating losses back ten years and obtain refunds for taxes paid in those years, thereby increasing capital. Proposed tax reform legislation would change the carryback period to three years and any excess losses would be carried forward. If this change were to become law, agricultural banks now incurring net operating losses would lose some of their ability to maintain an adequate level of capital.

We will work with the Administration, the bank regulatory agencies, and the Congress to obtain action early this year to relieve pressure on agricultural banks' capital structure.

Stabilization of Agricultural Borrowers

While we need action early this year to stem the erosion of agricultural banks' capital accounts, we also need stabilization of agricultural borrowers' debt situations and ability to cash flow their debt. For that purpose, we recommend further expansion of the Farmers Home Administration (FmHA) agricultural loan guarantee programs and authority. In the current budgetary situation, the FmHA loan guarantee program is the least costly means of stabilizing and extending agricultural debt. In addition, expansion of the $490 million interest rate buy-down program included in the 1985 Farm Bill would provide major cash flow assistance to agricultural borrowers at minimal direct cost. We also need clarification this year of the FmHA's preparedness to provide direct loans to qualifying farmers who cannot be financed in full by commercial lenders.

Stabilization of Farm Real Estate Values

We seek the development of an institutional secondary market for longer term real estate loans originated by commercial banks. A secondary market would provide access to additional funds and diversify the risks and returns from farm lending. One option is to pool FmHA-guaranteed loans for resale as mortgage-backed securities to investors.

Proposals for warehousing of problem agricultural loans and/or acquired assets also merit continued examination. Permitting banks to hold real estate assets for a longer period of time also merits consideration. Stabilizing land values is necessary to restoring health to the agricultural economy.

Comparable letter was sent to other bank regulatory agencies.

February 28, 1986

The Honorable L. William Seidman
Chairman
Federal Deposit Insurance Corporation
Washington, D.C. 20429

Dear Mr. Chairman:

As you know, the American Bankers Association and the Independent Bankers Association of America are concerned about the precarious state of the agricultural economy and the problems that are resulting to farm borrowers and their lenders. Because of this concern, a Joint Task Force on Agricultural Credit including membership from both of our Associations was formed, and the Task Force was charged with the responsibility of developing specific policy recommendations on what might be done to alleviate the situation. The recommendations of the Task Force, a copy of which are enclosed, have now been adopted as policy by both organizations.

The Report of the Task Force observes that time is of the essence in assisting commercial banks and their agricultural borrowers in coping with the accumulation of problem farm debt. We believe that regulatory action is preferable to legislative action because a regulatory program could be set in place within the next forty-five day period, which is a critical time for agricultural banks as they work with their farm customers in arranging for this year's operating loans. We commend the FDIC for its comprehensive policy analysis, Farm Bank Problems and Related Policy Options, which was sent to the Senate Banking Committee on February 18th. Our Task Force and your Agency seem to agree that there is merit in attempting to fashion a program "designed to buy time for participating in situations to resolve the problems created by five consecutive years of weak farm economy."

From a bank perspective, our Associations believe that the most immediate problem confronting agriculture banks is the development of a program to stabilize capital. The structural problems of agriculture are creating a massive amount of losses which have been absorbed by farmers, the government, and bankers in several different ways. Banks have acted with forbearance on many loans and attempted to work with their agricultural customers to the greatest degree possible. However, in a growing number of transactions, banks either have or will soon face the prospect of loan write offs which in turn lead to reductions in a bank's operating capital. Both the FDIC and the Office of Comptroller of the Currency seem to appreciate the dimension of this problem and your Report suggests that there is a realistic

possibility that a program of capital stabilization can be implemented on a limited term basis. We offer our assistance in working with you to accomplish this goal at the earliest possible opportunity.

It is our belief that over a period of time, agricultural banks in general have the management expertise to generate improved earnings to replenish their capital base. There are several possible ways in which to provide for capital stabilization. Two approaches which seem the easiest to administer are to either adjust existing regulatory policies by temporarily providing for capital levels below the present level of 6 percent or to provide for amortization of agricultural losses over a multi-year period. Bankers prefer the latter, and this approach was the Task Force's priority means for stabilizing capital.

A major attractiveness of loan amortization is that it preserves a bank's earning potential. Since a bank's individual lending limit is directly related to its capitalization, we favor a system that stabilizes capital without reducing loan limits and amortization of loan losses accomplishes both of these goals by regulatory action within the forty-five day time span that is critical for this spring's planting season. If capital reduction is pursued as the regulatory option, Congress should provide the regulatory agencies with the authority to keep a bank's lending limits at a nigher level during the administration of the capital stabilization program.

We are most anxious to work with you in the resolution of this matter. Please do not hesitate to call on our Washington staffs for whatever further assistance they can provide.

Sincerely,

B. F. Backlund
President
Independent Bankers
Association of America

Donald T. Senterfitt
President
American Bankers Association

Enclosure

The CHAIRMAN. Mr. Horsager.

STATEMENT OF LESLIE G. HORSAGER, VICE PRESIDENT, PRUDENTIAL LIFE INSURANCE CO., ON BEHALF OF THE AMERICAN COUNCIL OF LIFE INSURANCE

Mr. HORSAGER. Thank you, Mr. Chairman. We appreciate the opportunity to appear before your committee and express our views on the impact of the Farm Credit System Act and the proposed assistance to the rural banks.

I will make my remarks brief, since we have submitted a more detailed statement for the record.

In general, let me say at the outset, that we are very concerned that the Farm Credit System Act will, over time, lead to further federalization of farm credit, and that we support any plan that will keep the private agricultural banks competitive. We hope to work with these banks to develop the secondary markets for real estate loans.

PROVIDING $12 BILLION IN FARM MORTGAGES

I represent life insurance companies who have been actively providing agriculture credit for over 100 years. We presently hold $12 billion of farm mortgages, which equates to approximately 13 percent of the farm real estate mortgage market. For years we have worked hand in hand with country banks in formulating complete financial packages for their farm customers. The banks provided the operating loans, and we supplied the long-term real estate loans.

This system worked especially well until the 1970's, when the Farm Credit System received expanded authorities, which made it very difficult for us to compete with them and our insurance products required investments to be more liquid.

By way of example, I spent the 1960's in Marshall, MN, a centrally located agricultural town with a population of 10,000 people. During that period there were no less than eight farm loan fieldmen representing insurance companies living in Marshall, and we all originated our loans through working with area banks. Many of the banks worked with several of us to offer a wide variety of loan banks to their farm customers. Most of the 50,000 farmers who presently have real estate loans from insurance companies were originally referred to us from these rural banks, and they continue to rely on the banks for operating money.

Therefore, we are very supportive of measures under consideration that will help these banks through this difficult period and at the same time maintain a private system of agricultural credit.

It is in no one's best interest to see farmers become solely dependent on federally administered credit. We do, however, recognize the need for the 1985 Farm Credit System bailout but suggest that extreme care must be taken not to create two classes of farm borrowers and creditors.

Our lending has not been totally without problems. We enjoyed many good years, and we are now suffering through the same difficulties affecting other lenders. On a composite basis, our loan portfolios are now approximately 12 percent delinquent; however, our

broad diversification does permit us to use a wide range of tools to resolve delinquent loans.

For example, at Prudential we resolved $150 million of seriously delinquent loans in 1985 and only 15 percent involved an actual foreclosure. The rest were handled on a negotiated basis directly with the farmers.

We think it would be in everyone's best interest, if the farmers' mortgage market were more nearly balanced between the private sector and the Federal lenders, much as it was until the 1970's. Rural agricultural banks must be capable of offering their customers long-term real estate loans, if they are to compete with the new one-stop, full service loan centers created by merging the production credit and land bank associations.

Greater liquidity is the key to broadening private sector participation in agricultural lending. With the rapid changes in investment products being marketed, portfolio managers are reluctant to commit funds without the ability to remarket these investments, if their portfolios need to be repositioned.

Greater liquidity can be obtained through the development of a secondary market for agricultural mortgages, just as it was for residential loans. Securitization of farm mortgages would provide the opportunity for broad private sector participation and diversity of sources of farm credit throughout the economy; however, secondary markets for residential loans were only able to be developed after Congress established various mortgage programs.

We intend to propose the development of an agricultural mortgage insurance program that provides private sector lenders with the ability to share in insurance risks with the public sector.

We believe such a program can be self-financing, after its initial development, much like the residential programs are today. Accordingly, we recommend that Congress establish equitable policies for all agricultural lenders and find a way to enhance liquidity for agricultural mortgages through the development of a secondary farm mortgage market.

Thank you.

[The complete prepared statement follows:]

STATEMENT OF THE

AMERICAN COUNCIL OF LIFE INSURANCE

Before the

SENATE COMMITTEE

on

Banking, Housing and Urban Affairs

on

THE FARM CREDIT
AMENDMENTS ACT OF 1985 AND
ITS EFFECTS ON AGRICULTURAL LENDING
AND AGRICULTURAL BANKS

March 6, 1986

Statement Made By:

Leslie G. Horsager
Vice President
Prudential Insurance
Company

Mr. Chairman and Members of the Committee, I am Les Horsager, Vice President, the Prudential Insurance Company. The following testimony is submitted on behalf of the American Council of Life Insurance ("ACLI"). The ACLI is a trade association with a membership of 629 life insurance companies. In the aggregate these companies account for approximately 95 percent of the life insurance in force in the United States and hold 96 percent of the assets of insured pension plans.

Background

The life insurance industry is a provider of agricultural real estate financing of long standing. Many of the life insurance companies providing capital to agriculture today have been doing so for more than 100 years. Farm mortgages make a positive contribution to a well balanced investment portfolio. Insurance companies are familiar with the risks and rewards of farm lending.

The life insurance industry presently has just over $12 billion outstanding in mortgages secured by agricultural real estate, and, in addition, a significant amount is invested in agriculturally related businesses through bond and common stock holdings. It is our desire to continue that investment experience and to utilize our staff and infrastructure that has been carefully developed over the past century to provide private capital to agriculture on competitive terms. The life insurance companies have a successful record of perseverance and dependable service to

agricultural finance through good times and bad. We continue to support our respective portfolios of farm assets in an atmosphere of unrestricted, healthy, and efficient competition. We have taken risks and enjoyed the rewards. We have also suffered losses. Investment in American agriculture by private enterprises has always been a healthy and much needed activity for the agricultural borrower.

The Current Situation

Our industry is active in nearly every major farm state. New mortgages continue to be made today even in the face of the current agricultural situation. This further serves to demonstrate the commitment of the industry to provide capital to agriculture, as well as indicate that qualified and credit-worthy borrowers are able to obtain financing.

Life insurance companies' agricultural loan portfolios are not without problems. At the end of 1984, there was approximately $1.2 billion or 10% of the loans by volume delinquent or in foreclosure. This compares with $240 million or 2% in 1980. In 1984, insurance companies acquired by foreclosure just over $250 million in agricultural property. Preliminary indications suggest that these numbers will be higher in 1985.

The continued decline in the prices of agricultural commodities and assets and the uncertainty in credit markets contribute to the decline and instability of the agricultural sector. It also discourages new investment, increases the cost, and reduces the volume of credit that is available. This deterioration of the markets, together with the financial stress on the agricultural sector, is expected to continue in the near term and will negatively impact:

Federal, State and Local tax revenues
Infrastructure of the food production system
Services available in rural communities
Businesses that merchandise, process or market agricultural products
Agricultural credit sources

Widespread media coverage and public attention is being focused on the "Farm Credit Crisis." The Congress recently enacted the "Farm Credit System Restructuring and Regulatory Reform Act of 1985" (S. 1884) to reorganize and rescue the Federal Farm Credit System. While we believe strongly in preserving the financial integrity of the Farm Credit System, we are also concerned about the ability of other agricultural lenders to continue to participate in the industry.

The availability of several alternative sources of credit assures efficient and competitive markets for agricultural credit. A disadvantageous position imposed upon private lenders will discourage new sources of capital from entering the agricultural credit market, and encourage an exodus of those now active in providing credit. Any program designed to stabilize the agricultural credit industry over the long term must seek to insure continued private lender participation.

We hope and expect that if taxpayer assistance given the Farm Credit System ameliorates the pressures on Farm Credit System borrowers, equal benefit will be available to non-Farm Credit System borrowers. There is the potential here to inflict great inequities on non-Farm Credit System borrowers and creditors alike. Surely, the Congress does not intend to create a protected and privileged subclass of agricultural borrowers. In both the short term and in the longer term, this would be a grievous disservice to all concerned and indeed to the entire nation.

The Long Term

American agriculture should be a full participant in various American capital markets. We believe that this is clearly in the best interests of agriculture, of the taxpayers and of the nation in general. The alternative is that American agriculture increas-

ingly becomes a ward of the Federal government as to its credit needs.

In the past, when the life insurance companies held a bigger share of the market, interest rate competition was a much more common feature in the industry. Typically, the rural banks worked with local insurance loan representatives. This relationship allowed farmers that obtained short term credit from the banks to have insurance company financing available for their long-term mortgage needs. The insurance companies competed with each other and the Federal Land Banks, thereby providing diversified sources of long-term credit for farmers at competitive commercial rates, while giving the small country banks an opportunity to provide total packaged financing needs for their rural customers.

This system worked well for many years, but as the Federal Land Banks made increasing use of their government agency access to the capital markets, our participation in this industry diminished. The life insurance companies currently hold $12 billion or 12% of the nation's agricultural real estate debt. Our participation, however, has been greatly outpaced by the Federal Land Bank. In 1968, life insurance companies held about $5.5 billion of farm real estate debt, or 22%. At the same time the Federal Land Banks held $5.6 billion, or about 22%. By 1984 total real estate debt amounted to $111 billion when the life insurance companies' investment in agricultural mortgage financing reached $12.4 billion or 12%, while

the Federal Land Banks' position has grown to $48.4 billion, or 44% of the total.

During this time, private lenders, both the life insurance companies and the banks, operated at a disadvantage to the Farm Credit System. The Land Banks, for example, have been able to attract investors from the capital markets through a government agency affiliation which has provided them a lower cost of funds than other agricultural lenders.

We believe that competition and market discipline can be restored in the agricultural credit industry. To do so requires a healthy private sector lending capability. In our view, private lenders could compete, despite the pricing edge of government agencies, if there was adequate liquidity for their investment portfolios. While insurance companies may currently have a need for long-term farm mortgage investments, portfolio managers are reluctant to acquire significant amounts of these investments without assurances that they can be remarketed as their investment portfolios need rebalancing.

Liquidity has been provided in other long-term mortgage investments, such as the residential mortgages, through mortgage insurance and mortgage-backed securities. With an extensive secondary market for such mortgages, life insurance companies are once again major mortgage investors to the benefit of many home

buyers. In this regard, Mr. Chairman, I would note that the ACLI endorsed your efforts in the last Congress to enact S. 1821 and S. 1822 to enhance the potential of mortgage-backed securities and attract greater life insurance participation in that market.

Insurance companies believe the same concept should be developed in the agricultural mortgage business. If sufficient liquidity could be established through a secondary market for agricultural mortgages, our companies would be able to increase their participation as a major provider of long-term capital to agriculture, thereby increasing farmers' access to the nation's major capital markets. Just as homeowners in small communities throughout the nation have been served by the development of a secondary market for residential mortgages, farmers throughout the country would benefit from the development of a secondary agricultural mortgage market.

We believe American agriculture would benefit greatly from increased availability of private sector financing. The major advantages of private sector participation are several:

1. The private sector is enormous and highly diversified. Diversified sources of credit assure safety for farmers and investors alike.

The CHAIRMAN. Thank you, sir.

Before we turn to you for questions, Senator Dixon, I have to solve a very controversial issue, and that is whether we let the Senator from Minnesota testify or not, due to the fact that he is 1 hour and 50 minutes late. He was on the schedule and missed it.

Do you think we should allow him to testify?

Senator DIXON. Will he be, for a change, reasonably short, Mr. Chairman? [Laughter.]

The CHAIRMAN. I think he would be. Maybe we could ask unanimous consent that he be allowed to proceed for 2 minutes. [Laughter.]

Senator DIXON. I would grant him that.

Senator BOSCHWITZ. I'd object. [Laughter.]

The CHAIRMAN. Senator Boschwitz.

STATEMENT OF RUDY BOSCHWITZ, U.S. SENATOR FROM THE STATE OF MINNESOTA

Senator BOSCHWITZ. Thank you, Mr. Chairman. I talked to the American Newspaper Association this morning, and then I was at a hearing at the Foreign Relations Committee with respect to the——

The CHAIRMAN. I didn't ask for excuses. [Laughter.]

We gave you permission to proceed.

Senator BOSCHWITZ. I must say I heard only a little bit of the testimony of the final witness. I certainly agree with the idea that there should be more broadly based lending in the long-term market in agriculture, and of course, part of the problem that the Farm Credit System is now having is that unlike Prudential banks and other financial institutions, they are totally drawn to the agricultural market, and so when it goes bad, they have real problems.

INTEREST RATES ARE STILL AT 13.9 OR 14 PERCENT

Mr. Chairman, one of the problems we now find in rural agricultural lending, frankly, is the result of the Farm Credit System charging very high rates as it tries to make itself well. The PCA's and the land bank, because they have been charging high rates in the rural areas, for example, our PCA is about 13.9, 14 percent, then provide a cushion for a bank that has a 9.5-percent prime. We borrow in our business at 10 and 10¼ percent, but yet bankers are out there in the rural areas, with their competition loaning at 14 percent, and the result is that agriculture's interest rates have not fallen as quickly.

If your competitor is loaning at 14, and you are perhaps capable of loaning at 10, 10.5, or 11, the temptation to loan at 13 is very great. And unfortunately, that is happening. Banks that have over $500 million in assets loaned at an average of 11.2 percent in 1985, but rural banks were at 13.4 percent, so its clear the relief in rural America has not been as great as it has been in some of the larger metropolitan areas. Though the rates didn't go quite as high, they certainly have not come down as they have in the more urban settings.

I feel, Mr. Chairman, that the farm credit picture is far more easily solved than the problems of trying to compel high prices or

bring about high prices by influencing the market. And I really feel that the farm credit problem is at the root of most of the real travail that is found in rural America. It is not only easier but a good deal cheaper to solve, and I think what we did with the Farm Credit System was good, but it is proceeding too slowly, very frankly, and the result is that there still is not relief in the rural areas.

Sometime ago, Senator Dixon and myself and others introduced legislation that you are very familiar with that I understand you now are holding these hearings with the intention of seeking whether or not such legislation would be advisable. But I think that farm credit is not that difficult to solve. If we move with some dispatch, if we get Federal and State Governments involved, together with the lenders themselves we can make a difference this spring. In addition, I think that a large segment of the loans found in the hands of individuals, that if we were to reduce for a period of time, say a 3-year period, the imputed interest rate, that would help a great deal.

Now, 29 percent of the long-term debt is held by individuals. Also, 18 percent of the short-term debt is held by individuals. That is debt that is beyond the Farm Credit System, and is the second largest pool of debt held by one group, clearly larger than the private banks themselves and certainly much larger than the insurance companies.

So we can, I think, help individual lenders and their borrowers, where they are interacting with one another, quite quickly and quite readily by doing that.

Banks, I think, can be helped by extending the period over which they can write off their losses and also perhaps getting into an interest buydown, which I very firmly support.

I know that the Senator from Illinois has introduced a bill that would allow them to write off their losses over 30 years. It is not clear to me that they need quite that long a period by any means, but nevertheless, the writeoff over a period of years would certainly help. The FmHA, I think, Mr. Chairman, really has a large number of tools that they can utilize now, and they are utilizing them, despite what we may read in the papers to the contrary. We have helped the Farm Credit System. We need to push them a little faster. We perhaps can, by also making available to them the option of writing off some of their loans over a long period of time and having the interest buydown apply to them, as it would apply to commercial banks, and also having individuals able to lower their imputed interest rate, we could, in my judgment, go a long way, very rapidly, at relatively modest cost in relieving some of the stress that we find in the rural parts of our country.

So I compliment you, Mr. Chairman, for moving expeditiously to consider this problem. I hope that the committee will continue the pace of its efforts, because that would be a great deal of relief granted to the rural parts of the country that finds itself in considerable distress.

I believe we should do the things that I know that you are considering, the Senator from Illinois and I have been suggesting, and so we urge you on.

The CHAIRMAN. Thank you, Senator.

I would say that earlier in the hearing, we discussed the pace. Senator Dole was here to testify, and what the committee would like to do is complete our hearings next week, move to markup as rapidly as we can, attempt to obtain a consensus—that may or may not be possible—with the full Banking Committee and move as expeditiously as we possible could. And the Senator from Kansas indicated he would try to find time on the floor to do that.

So we will move as rapidly as we can. I can't predict exactly what a bill will look like at this point, or what we will be proposing.

Senator DIXON. Mr. Chairman, may I say, as usual, the distinguished Senator from Minnesota was well worth waiting for. I want to say that. I would like to also say incidentally to him that——

The CHAIRMAN. Well, just speak only for yourself.

Senator DIXON [continuing]. Most of this testimony morning was in connection with S. 1943, which is actually the 10-year amortization bill. So I hear the message of my colleague and I think we are discussing the shorter terms of time.

Senator BOSCHWITZ. Did I exceed your 2 minutes?

Senator DIXON. Just barely.

The CHAIRMAN. All of you need to understand—I suppose I shouldn't leave it hanging with all my sort of sarcastic remarks about the Senator from Minnesota. I think most of you know you don't make remarks like that unless you are friends. He is insulting to me and I am to him, and it's been a continuing battle for several years. You don't say nasty things about people unless you are a friend.

Senator BOSCHWITZ. If you would yield, Mr. Chairman. Before you define me as a friend, a number of your colleagues noted considerable differences in you when you returned from that trip that you took, and we aren't sure what happened on that trip, but——

The CHAIRMAN. Nothing. A lot of people thought I was weightless from the neck up before I went! [Laughter.]

Senator BOSCHWITZ. I certainly didn't want to say that, Mr. Chairman——

[Laughter.]

The CHAIRMAN. Thank you, Senator.

Senator BOSCHWITZ. Thank you, Mr. Chairman.

TIME PERIOD FOR WRITEOFFS

The CHAIRMAN. A request that banks be permitted to write off loans over a period of years. Mr. Killebrew and Mr. Backlund, how many years are you talking about? We've heard 30, we've heard 10, we've heard 5 years. We've got a little bidding going on here. What is your recommendation for a reasonable period of time?

Mr. BACKLUND. Well, any multiyear proposal is better than what we have now. The banking community believes that the longer the better. I think the 10-year period proposed by Senator Dixon would be very, very favorably received.

The CHAIRMAN. What is the minimum, Mr. Killebrew, that you think would be necessary to really be of assistance?

Mr. KILLEBREW. I think 5 years would be the minimum that would be of any assistance. Anything short of 5 years, I think, would be of limited value. Amortizing a fairly large amount of loan losses in 5-year periods of time would still have a major impact on the earnings of the bank, and what we need to do is restore those earnings streams and allow the capital to be maintained through those earnings.

The CHAIRMAN. Mr. Backlund, the argument has been made that as a matter of equity, title II of Garn-St Germain should be extended beyond thrifts to agricultural banks. We also have a problem in some sections of the country as far as energy-related loans.

As a matter of equity should they also be extended to energy-related banks?

Mr. BACKLUND. You're talking about the net worth certificate?

The CHAIRMAN. Yes; title 2 of Garn-St Germain.

Mr. BACKLUND. Yes, as a matter of equity, I think it could very well be extended, but I think we'd prefer the Loan Amortization Program to the net worth certificate. As I said, in all these meetings of bankers on this agricultural problem, the ag task force, the ag committee of the IBAA, the ABA, the special meetings have been held and they would ask these bankers what is the preference of all these options, and 80 to 90 percent consistently preferred the loan amortization for a multiyear period.

The CHAIRMAN. Mr. Killebrew, you heard the testimony of Mr. Sethness regarding the provisions of the 1985 farm bill that authorized a $490 million Interest Rate Program.

What is your reaction to that program, and what do you think the results of it will be?

IMPLEMENTING REGULATIONS

Mr. KILLEBREW. Well, first of all I am eagerly waiting for our local FmHA office to get some regulations, so we can know how it is going to be implemented. I happened to talk with them last week, and they have not received those regulations, and they felt it would probably be at least 2 more weeks before they would have them and be at the position to accept applications at the local level. So I think that it is a step in the right direction, and I currently in our bank have at least two applications. We are waiting for the regulations to come out, so that we can make application for those borrowers.

Mr. BACKLUND. In these proposals that come out of Washington, from the Agriculture Department, the FDIC, or wherever, to implement them in the field is very difficult, because of the shortage of personnel. In the banks I am associated with, we have had very little success with trying to get these writedowns or loan guarantees. It is very frustrating. It takes so long that our people have just kind of given up on that. And that's why I think, as Secretary Sethness said, it should be taken in that light, that there is a problem out in the field. Loan amortization should be couched in such a way that it can be easily implemented. That is why I have a problem with only directing the program at qualified agriculture banks, and what is a qualified loan?

I think if you had a program where any agricultural related loan could be amortized over a period of time, then you would have the disincentive that Secretary Sethness talked about that the bank would have to implement regarding expenses or dividends or whatever, so that they could make a decision very quickly out at the small bank level without a lot of involvement with personnel in the field.

Mr. KILLEBREW. Mr. Chairman, if you would, I would like to respond to one other thing that Secretary Sethness indicated about the DAP Program which was enacted last year and the limited response to that program. Again, that limited response was a great deal due to the implementation on the local level, and it was past the planting stage before the local FmHA offices were in a position to accept and process those applications. And I again have personal experience with the amount of time. It was late summer, before we finally got the final processing of those type of applications. And timeliness is something of great importance with these programs.

Mr. FITCH. Mr. Chairman, if I might, we have the added problem in the Western part of the United States with unrealistic eligibility requirements through the Farmers Home Administration. For example, one eligibility requirement is that if a farming entity has more than two full-time employees, they do not qualify as a family operation. In some labor-intensive vineyard or orchard crops, we have people that clearly are bonafide family operations, but because of that type of an eligibility requirement are not able to avail themselves of that type of program.

The CHAIRMAN. Mr. Horsager, in general, could you describe the nature of life insurance companies' involvement in private agricultural lending—is agricultural lending an area in which your companies wish to continue to participate?

CONTINUED PARTICIPATION

Mr. HORSAGER. I don't think there is any question but what we would like to continue participation. That obviously is the reason we are here today. Our problem has been one that our lendable funds have really needed to be more liquid, and as we have tried to block up packages of farm mortgages and move them into the secondary market, we continually run up against the same problem, and that really is one that the buyer of those packages of mortgages just plain doesn't understand—farm lending. And they look at it and they read the newspapers, and they just back away from it. And so we certainly want to be a big player in it. We would like to get back to the position where we shared the farm mortgage market approximately 50–50 with the Federal land banks, but we just have to be able to put some liquidity into those blocks of mortgages, so that when our products change, we can reposition our portfolios quickly to respond to the liquidity needs in the portfolio. We definitely want to be a player.

The CHAIRMAN. Mr. Backlund, Mr. Sethness pointed out that the emergency acquisition provisions of Garn-St Germain severely restrict acquisition of troubled banks across State lines.

What is your position on eliminating the $500 million asset test to make failed agricultural banks more attractive to out-of-State buyers?

Mr. BACKLUND. Our position is that we don't want to see that lowered beyond that. We think it is extremely important that the community banks' decisionmakers, standard setters, continue to live in the communities and be involved in the communities in which they serve. And if you allow that, then you would lose that. So we would not favor a lowering of that.

The CHAIRMAN. I didn't expect that you would. [Laughter.]

Senator Proxmire.

Senator PROXMIRE. I am delighted to hear that answer. Good for you. [Laughter.]

Mr. Killebrew, I thought your name was Harmon. [Laughter.]

You know, in Washington, Harmon Killebrew is a great hero. Those of us who have been here a while remember that great home run hitter, now in the Hall of Fame, I guess.

The CHAIRMAN. From Idaho.

Mr. KILLEBREW. By the way, his father was from Illinois.

Senator PROXMIRE. His father was what?

Mr. KILLEBREW. His father was from Illinois. So he comes from good seed stock.

Senator PROXMIRE. Oh, yes, near Wisconsin. [Laughter.]

But I am happy to see that the ABA has sent up a heavy hitter.

Senator BOSCHWITZ. If you would yield, Senator, I would certainly want to point out where he did his playing and his good work—in Minnesota.

Senator PROXMIRE. Well, we certainly want to forget that here. Minnesota stole him. [Laughter.]

Mr. Killebrew, this is apropos of your remark that the fundamental problem is increasing farm earnings. Obviously, it is not going to do any good to provide all the credit in the world, if farmers don't have the earnings that will enable them to pay it off.

FALLING FARM EXPORTS

In the 1970's, it was generally reported and believed that the demand for large U.S. food exports would persist well into the 1980's and 1990's, because Third World food production would be unable to keep up with the demand of a growing population. As a matter of fact, Global 2000 report predicted a doubling of food prices. The value of farmland increased. The farmers were urged to increase planted acreage, and it was assumed that one-third of all farm acreage would continue to be exported.

Instead, wheat exports fell from 49 million tons in June 1984 to 38 million tons in June 1985 and are projected to be only 28 million tons this year. Many experts now contend that the era of large U.S. farm exports is over, due to the ability and the need of Third World countries to grow their own food.

Now if that is true, will the proposals you are suggesting to alleviate today's farm crisis only cause us bigger problems later? Is your solution based on a premise that U.S. farmers will eventually reverse their continuing loss of foreign markets, or is it based on the notion that they can get along without foreign markets?

Mr. KILLEBREW. Definitely, the foreign markets are going to continue to play a large part in American agriculture. The falling dollar should begin to restore our competitiveness in those foreign markets. The people who have those markets today are not going to give them up easily, and it is going to be a tough fight for us to regain our position in some of those markets. And by the way, part of the problem with the foreign markets is a result of another very successful Government program, where we sent some of our very, very best agronomists and plant scientists to India and other countries and developed new strains of rice and wheat and taught them how to use fertilizer and new farming practices. And all of a sudden, rather than being importers of wheat and other feed grains, they are now net exporters.

So that the result of one program that was very successful has caused us some problems in the farm community. Farming was and probably will continue to be a very cyclical business, and we are in the downturn of that cycle now. I don't think any of us can really accurately predict what may happen 2, 3, 4 years down the line with agriculture. If we were seated here 1 year ago, could we have predicted that oil prices would be at under $20 a barrel or that we would see interest rates at the current levels they are.

You know, I think our ability to forecast the future in any of these instances is very limited.

Senator PROXMIRE. Well, I agree wholeheartedly with that, and I agree with you on the notion that farming, like banking, like everything else in this country, is cyclical; however, my question was directed at the long-range permanent structural change, and that is what really concerns us here in the Banking Committee. Many of us are from farm States, and we are very anxious to do all we can to help farmers. We want to also make sure that we do it in a responsible way.

Mr. Fitch, you wanted to add something?

Mr. FITCH. Senator, I think you are asking such an important fundamental question that I really would like to respond, because I think right now more than ever, agriculture needs capital, both in form of debt and equity, in terms of new equipment and new technologies, in order that we can regain our competitiveness overseas. Clearly, the U.S. market is a mature market. If we are going to grow, it will have to be overseas. I believe that there is a growing market over there. Demographers tell us that the world population is still growing at a net rate of almost 200,000——

Senator PROXMIRE. World food production is growing too, though, isn't it?

Mr. FITCH. That's right. The key is, though, that the people are where the money is not. I think the problem we are having in the capital markets right now, equity as well as debt, as it pertains to agriculture, is, I believe, they are all waiting for some signals as to where agriculture lines up in this Nation's priorities, particularly as it compares to Japan and to Europe. And I think the way that that signal can be emitted, for example, is a recommitment to research and extension, which has really allowed us to be at the leading edge and to be competitive, and a commitment to, indeed, promote exports and to do some innovative things to convert this fundamental demand there into an effective demand.

Senator PROXMIRE. Mr. Backlund, let me ask you, the administration's contended that the vast bulk of agricultural banks are still in good shape, and that we don't really need a major new program.

What is your response to that view?

Mr. BACKLUND. Well, I don't completely agree with that, the implication of it, anyway. I think that most of the banks are in fairly good shape. I think that is true, but they also are looking at possibly substantial losses and each banker is an individual who looks at his portfolio a little differently. And as a personality, small bankers are very conservative with a lot of involvement, financially, in their own institution. In human terms, there is a tremendous amount of anxiety and stress among those bankers which prevents them from making good decisions in regard to managing their loan portfolio.

This message that you would send out there with a loan amortization program or whatever it turns out to be, either with a bill or through the regulators, is tremendously important in making the structural change that I agree with you, Senator, is happening in agriculture. I think it will help the transition to have less human suffering, less loss of communities, and so on, if we do something like this, just to buoy up their morale, so to speak. It is tremendously important from that standpoint, from the human standpoint.

Senator PROXMIRE. One of the problems we face when we take this legislation to the floor is the possibility that people on the other side can argue that the aid is primarily bailing out banks, and it won't get through to the farmers.

Mr. BACKLUND. It will.

Senator PROXMIRE. Now how do we answer that? How do we convince our colleagues that we are not bailing out banks, that our concern is for agriculture?

Senator DIXON. I think that is a key question. I congratulate my colleague on asking it.

BANKERS AND FARMERS ARE A TEAM

Mr. BACKLUND. I think most of the feedback you are getting from out on the Great Plains and from the Midwest is that generally the farmer, the farm communities are very supportive of their bankers. Certainly, there are exceptions to that, but I think most people realize how sensitive and involved the bankers have been. I don't know if you saw the "Phil Donahue Show" on television on which one of our banker friends from Dubuque, IA, appeared with some other people, and the audience, 10,000 farmers, the people involved in farming in this basketball arena in Cedar Rapids, were very sympathetic to this banker. And I talked to him about it afterward, and he said, you know, this was heartwarming to him, the fact that he didn't get boos and catcalls, which he thought he might.

Senator PROXMIRE. But how can we be sure that the aid is passed through to the farmers?

Mr. BACKLUND. Well, you just have to have faith in these country bankers. Their friends' lives are at stake here. They're not going to handle this in an impassionate way. They are very concerned about

keeping these people afloat and having them stay in farming, if they can. In many cases, Senator, it is a real human thing to do is to tell a person he is better off if he goes into something else. If he doesn't have the strong capital base, if he doesn't have the real good productive land, if he doesn't have the management skills and the dedication, he is better to find another location.

Senator PROXMIRE. Well, I'll tell you one part you answered at the very beginning, when you pointed out that it makes a world of difference when the people who own the banks also live in the community and are part of the community and their headquarters isn't in New York City or Tokyo or Minneapolis or Milwaukee or someplace else, but is in the community.

That is one of the great things about Illinois. I am glad you have Illinois today. It's Illinois day today, with these fine witnesses from Illinois. Because Illinois, as I understand, has lived by that more than any other State in the Union. A lot of people don't like it. Maybe you don't like it. I don't know. But at least you make sure that the big city bank doesn't come down and own all the regional banks.

Mr. BACKLUND. We have an excellent diversified system in Illinois.

Senator PROXMIRE. I just have one other question, and this is for Mr. Fitch.

Mr. Fitch, the FDIC has reported that in principle, there is no difference between a net worth certificate approach and a loan loss deferred approach.

Would you agree, or do you have a preference?

Mr. FITCH. Senator, I don't feel qualified to respond to that, because, as a publicly held bank, neither of those would be mechanisms we would find attractive, simply because of the accounting provisions that we're tied to in SEC regulations.

So I think I need to defer to both colleagues here.

Senator PROXMIRE. Mr. Killebrew.

PREFER LOAN LOSS DEFERRAL PROGRAM

Mr. KILLEBREW. Well, I would respond, first of all, from a banker's standpoint, I think the deferral of loan losses is much easier to understand and much easier to administer than the issuing of net worth certificates. I think that in issuing net worth certificates you again get into the bureaucratic process and you probably increase the amount of administration necessary to administer that type of program. The loan loss deferral should be a fairly simple straightforward procedure that could be done without a great deal of administrative costs.

Senator PROXMIRE. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Dixon.

Senator DIXON. Thank you, Mr. Chairman. May I say to the witnesses, that I think it is apparent to them from what they have heard today, from the supportive remarks of the chairman and the ranking member and from the majority leader, that there is a great likelihood of a markup on some kind of legislation, similar to what we've discussed, and that there is sufficient consensus in the

committee that there is a good likelihood the bill will go to the floor.

Now I want to echo what my friend from Wisconsin has just asked you. There will be some that will want to say, "Well, this is great for the banks. Give them an opportunity to amortize this loss over a period of years."

I want you to put on this record, why this is good for the farmer. The Farm Bureau has endorsed this legislation, as well as your organizations, and the question will be raised on the floor, how does this help the farmer? So if we have a Loan Deferral Program, and we talk about the number of years in due course here, how will that specifically help the farmer, not your bank, but the farmer in Petersburg, in that area?

Mr. KILLEBREW. Well, first of all, Senator, in our State of Illinois we can get some examples where banks have failed and gone to purchase and assumption with the FDIC. And I think we will find it's made it very, very disruptive to the community and very disruptive to the borrower, and the borrowers have suffered as a result of that very disruptive practice. So if we can use loan loss deferrals and keep some banks open without going through a purchase and assumption procedure, we have done a great deal toward stabilizing the local lending environment.

BENEFITS TO THE BORROWER

I think that there are ways to structure the thing, so that the borrower does benefit. I think if you will look at the DAP Program last year, you look at the interest rate buydown that is in the current farm bill, and the proposal by Senator Boschwitz, the banks have to give up something. They have to give up—to get a guarantee, they've had to give up and write down principal and forgive principal. They've had to write down interest and forgive interest, in order to meet the test. And there are ways this can be structured to make sure that the borrower is going to be the ultimate beneficiary.

Senator DIXON. Isn't it more likely that you would be more likely to accommodate the borrower and to write down that loan and to put him in a position to be able to meet some kind of cash flow requirements with your institution, if we passed some kind of a law like this?

Mr. KILLEBREW. That's right. And the greatest service that we can be to the small communities, especially, is to make sure that there are banks there to service the credit needs and that there are alternatives, that the Farm Credit System is going to be there. Let's have some banks there, let's have the insurance companies there to provide some long-term credit, so the borrower has a choice and is not limited to only one source of credit, because when we get to a situation where they are limited to one source, we are in dangerous waters.

Senator DIXON. Now let me ask you this question, because it will be a practical question, I suspect, for the committee, Mr. Chairman.

My original bill, as you know, that was defeated 44 to 47 on the floor last year on the 1985 Farm bill, had a 30-year amortization

opportunity. The bill we're talking about, I think, today, more significantly, is S. 1943, which has a 10-year amortization.

Questions have been asked by others about what are the ideal number of years? And I'm sure that when the committee reviews this, and we have our internal discussions, a lot of time will be spent on how many number of years ought to be employed in the amortization period.

And I would like you to address that, if you can, to show us what, in your view, is the more reasonable number of years to use, from the standpoint of the institution itself, the bank, and also from the standpoint of the borrower, from the standpoint of the community as a whole and from the standpoint of the FDIC and others, as well, the regulators, as well.

Can you do that?

Mr. BACKLUND. Are you asking me, sir?

Senator DIXON. Yes.

Mr. BACKLUND. Well, I think 10 years, quite honestly, Senator, is more realistic than 30, because of the safety and soundness implications. Actually, what we are doing here is allowing banks to operate at lower capital over a period of time, and that puts an additional liability on the FDIC fund. So if anybody is funding this sort of proposal, it certainly isn't the Treasury or the taxpayer. It is the banking system which is assessed.

So from that standpoint, I think 10 years is a realistic time period, and I agree with Randy that 5 years is probably the minimum that would be of help. So I think you are dealing in that range, and certainly, I am sure that you will have the regulators who will be involved in this process also, and they will have their point of view. After listening to Secretary Sethness, I am sure they prefer the shortest timeframe possible.

Senator DIXON. Well, I am sure of that too, and that's why I'd like to hear the argument against that, if I may, for the record.

You heard the comments of my friend from New York State before he left, felt it ought to be 10 years. I am sure that the regulators somewhere along the line, Mr. Chairman, will say here, well it ought to be as short as possible.

So I am asking you what is the argument against making it as short as possible, from the standpoint of the borrower and the lender, independent of the regulator?

LONGER PERIOD ALLOWS GREATER COMFORT LEVEL

Mr. BACKLUND. What I was saying, we are trying to raise the comfort level of this small town banker, who is so deeply involved with his friends, his business, and his livelihood and his life, that the longer the time, the higher that comfort level and the better he is going to be able to deal with these problems.

Senator DIXON. Let's talk about the farmer.

Mr. BACKLUND. All right. Let's talk about the farmer.

Senator DIXON. Let's talk about him. What about from his standpoint?

Mr. BACKLUND. From his standpoint, if a farmer is a marginal borrower, and many of them are, and his bank's lending limit is reduced because capital goes down, and his bank comes in and

says, you know, we've been loaning you $100,000, and now we're down to where we can only lend you $50,000 because of our lending limit, you are going to have to go and get this additional money someplace else. There just isn't any place to go now. Everybody is staying away from these farm loans. The small town banker can't go to his correspondent bank. They're staying away from it. They've got losses that they are concerned about.

So it is extremely important to the marginal farm borrower, that his bank keep its lending limits up. Extremely important.

Senator DIXON. May I ask this of you and Mr. Killebrew and others.

If the amortization period is longer, stay 10 years, rather than 5 years, is the likelihood of your accommodating the farmer and reducing the amount of the loan and writing off the loan by amortizing it over that longer period greater?

Mr. BACKLUND. Oh, absolutely.

Senator DIXON. And would the writeoff be greater? Would the amount of the reduction probably be greater, if you have a longer period to write it off?

Mr. BACKLUND. It could be, and if you are amortizing the loan over a longer period, it means that you are more likely to stick with that farmer.

Senator DIXON. Mr. Killebrew.

Mr. KILLEBREW. Well, I think there is a possibility of maybe tying the two together, from the standpoint that if you have to restructure a farmer's debt, a part of that restructuring is the fact that the bank is going to forgive or write off a portion of that and restructure the balance over a period of time. Maybe that period of time is going to be 5, 7 years that you are going to give the farmer to earn his way out and pay you back the balance of that principal. Then maybe you could take the amount that you had to write off and amortize it all over the same length of time.

So that if you are going to extend that line of credit to the farmer for 7 years, then the portion of it you write off, you amortize over 7 years. There are ways that that can be structured, so that it is equitable to both the financial institution and the borrower.

Obviously, if you attempt to amortize it too quickly, all you're doing is deferring our loan losses into the next two or three accounting periods, and you are probably going to continue to erode the earnings of the bank.

Senator DIXON. Isn't that exactly the point, that you need some time work with the farmer? If you have more time, your opportunity to work for that farmer and work with that farmer to benefit that farmer is greater. So the shorter period of time, the less opportunity to work this out with the farmer. The longer period of time, the more opportunity to work this out with the farmer; isn't that true?

Mr. KILLEBREW. That's true.

Senator DIXON. So time, so far as we grant you time to defer these things and amortize over that period time, the more time we grant you, the better it works in the interests of the individual farmer you are dealing with.

2. The private sector is innovative and fiercely competitive. Such features have historically acted to the benefits of its customers.

3. The private sector could promote the development of a secondary market for agricultural mortgages thereby providing a method to recycle capital from the major capital markets back into rural areas.

A basic feature of private sector financing is that its interest rates and terms are, at all times, reflective of the current capital markets. Some will say commercial agriculture cannot afford financing at commercial rates and terms. This is, in our experience, not the case. Realistic interest rates encourage realistic borrowing and provide an on-going discipline for all enterprises that use borrowed capital.

Given the tendencies of land prices to appreciate excessively when below-market financing is available, it can be asserted that in the long run agricultural assets will be more soundly priced and valued if interest rates are at commercial market levels. Viewing the last ten years, this would certainly have been a blessing to all concerned.

We believe American agriculture would benefit greatly with increased availability of private sector financing. Indeed, what agriculture needs is direct access to today's capital markets where interest rates have dropped significantly in recent months. Clearly, the American taxpayer would benefit in two ways. First, most private sector sources are subject to Federal income taxation on their investment income. Second, the possibilities of a repetition of this current demand for massive bailout would be materially reduced since sources of agricultural credit would be spread more diversely amongst investors.

For these reasons, we recommend that an equitable treatment of all agricultural lenders be established as a matter of on-going public policy. We also recommend that Congress seriously consider ways to enhance liquidity for agricultural mortgages through the development of a secondary market. We believe this will result in greatly increased private sector participation to the betterment of both lenders and borrowers.

Mr. KILLEBREW. There is one other thing here, I think, that needs to be part of your consideration on this, and that is, the Internal Revenue Service has a different interpretation when we start writing off or forgiving principal and how that is treated for tax purposes for the borrower. That needs to be addressed as part of this whole package, because I know of situations personally where the lender and the borrower are able to reach an agreement on restructuring a debt and either forfeiture of assets or payment of debt or the lending institution forgiving debt and restructuring the balance, but that causes a tax problem for the borrower. That needs to be addressed as part of your overall program.

The CHAIRMAN. If I can interject, we don't have jurisdiction of taxes in this committee, we do windows, housecleaning, and a few other things. [Laughter.]

So we can't put that as part of what we're talking about.

The Finance Committee would be very upset with us. So if that's a problem, I have learned enough about jurisdiction and turf around this place, I am not going to touch taxes in this committee.

Senator DIXON. Let me ask one more question for the record, Mr. Chairman——

The CHAIRMAN. Sure.

Senator DIXON [continuing]. Before we adjourn for lunch.

Would you all indicate what you think is the appropriate timeframe for doing this. Assume that the committee can hear all the regulators and other things we have to do and get to a markup within a period of 10 days to 2 weeks or so, depending upon the many obligations of the busy chairman of this committee, what is the timeframe on when we ought to get this bill passed and to the President's desk, in order to accommodate the concerns out there in agricultural America?

Mr. BACKLUND. Senator, timing is tremendously important, and it needs to be done today. So anything you can short circuit on the time will have a tremendous value. To come up with your consensus very quickly, so it can be spread out into the agricultural community, would be of help also.

The CHAIRMAN. Thank you, gentlemen. Your testimony has been very helpful. The committee is adjourned.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

FARM CREDIT ADMINISTRATION ACT AMENDMENTS OF 1985

TUESDAY, MARCH 11, 1986

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, D'Amato, Gorton, Mattingly, Hecht, Gramm, Proxmire, Cranston, and Sasser.

OPENING STATEMENT OF CHAIRMAN GARN

The CHAIRMAN. The Banking Committee will come to order.

Today we continue our oversight of the effect of the farm crisis on financial institutions in agricultural lending.

At my request, the bank regulators undertook an analysis of the situation and submitted options as to how they and Congress might ease the strain resulting from such lending commitments.

The focus of this hearing will be to explore the specifics of the regulators reports. As I indicated at last week's hearing, after completion of the hearing process, it is my intention to work toward markup of a proposal to assist farm banks and borrowers through this transition period. The contents of such a measure have yet to be determined. There is a general understanding among interested parties that we should work to develop a consensus package which addresses the problems effectively, responsively, but avoids becoming a legislative Christmas tree.

Furthermore, Senator Dole has pledged his willingness to schedule floor time for our effort.

Last weeks hearing produced a full discussion and valuable insight on some credible suggestions. I expect more of the same from today's hearing.

Today we will hear from William Seidman, Chairman of the FDIC, Robert Clarke, Comptroller of the Currency, and Preston Martin, Vice Chairman, Board of Governors, of the Federal Reserve.

Mr. Martin will be accompanied by William Taylor, Director of Bank Supervision of the Federal Reserve.

Before we do that, we will begin with Members of the Senate.

Gentlemen, if you would like to come up to the table.

Before I turn to you, I would ask my colleagues if they have any comments they wish to make. Senator Hecht.

Senator HECHT. Thank you, Mr. Chairman. No comments.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. I thought you were going to get me this week like you did last week.

The CHAIRMAN. Just seeing if you're alert and awake.

Senator MATTINGLY. I just want to commend you again for holding the hearings. I think these hearings demonstrate the importance of the issue and interest here in the Congress. I think everyone over the country is concerned about agriculture and wants us to develop a consensus.

I have the greatest confidence in this chairman being able to do that. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Heinz.

PREPARED STATEMENT BY SENATOR JOHN HEINZ

Senator HEINZ. Mr. Chairman, thank you for having this second day of hearings on the farm credit crisis and I welcome our guests.

Last week we heard a disturbing litany of the problems befalling the agricultural banks mostly concentrated in the Midwest and West. Of the 120 banks that failed last year, 62 were agricultural banks—a startling increase from the 25 agricultural banks that failed in 1984 and the 7 that failed in both 1982 and 1983. Farm production loan losses charged off by insured commercial banks totaled $900 million in 1984, up from $436 million the year before. In the first three quarters of 1985, chargeoffs came to $755 million. At this rate, chargeoffs could reach $1.5 billion for all of 1985.

There is no question that something must be done to help the agricultural banks and, more importantly, the farmers who are dependent on the agricultural banks in their communities. This committee must decide the best way to address the problem.

Most often mentioned last week was a plan to defer loan losses by allowing them to be amortized over 5, 10, or 30 years. Also mentioned were net worth certificates for agricultural banks. I am interested in hearing your views on these proposals. If either of these approaches were to be adopted, for how long should they be in place? What strings should be attached to either an extended loan loss period or net worth certificates?

Also mentioned was an expansion of the types of institutions that could acquire failed or failing banks. I would be very interested in hearing your thoughts on this proposal.

Last week's hearing revealed many options for dealing with the crisis our farmers face in obtaining credit in the agricultural community. I look forward to the testimony of our witnesses today.

Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, we're happy to have you with us this morning. Wait till you see the questions we've got for you. We've just been waiting for you to appear before us.

Senator Nickles, would you like to begin?

STATEMENT OF DON NICKLES, U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Thank you, Mr. Chairman. I appreciate your interest in solving some of these problems that we're having in agricultural banks and banks throughout this country. I appreciate your leadership, your willingness to meet with this Senator on several occasions dealing with some of the problems like Penn Square that we've had in our State. Especially, you've shown a great deal of cooperation and leadership, and I'm most grateful.

BANK FAILURES

Mr. Chairman, it goes without saying, we've got some very serious problems throughout the State and throughout the agricultural economy. In my State of Oklahoma, I think it probably hits closer. Maybe the problems are even greater than in most States. In just looking at the number of bank failures throughout the Nation, I see in 1983, there were 48. In 1984, there were 79, and in 1985, there were 120. So the number of bank failures has risen substantially throughout the country.

In my State of Oklahoma, since the Penn Square Bank failure of July 5, 1982, there have been 24 bank failures in my State alone. In 1984, there were 5 bank failures and last year, we had 13 bank failures. That is 13. Nationwide, there were 120.

Statistically, just to show you a listing, and I'll submit this for the record, but you can see that it's mostly in the Farm Belt portion of our State, and most of the banks that failed are what we would classify as agricultural banks, or many of them were, the majority of them were. A lot of them had high incidences of loans, both in energy and agriculture, both of which are in severe financial straits today.

So the plight that we find agriculture in, the plight that we find the energy industry in, also applies to the banking industry in our State, and not only in our State, but throughout the Southwest and throughout the Farm Belt.

[List of bank failures in the State of Oklahoma submitted for the record follows:]

OKLAHOMA BANK FAILURES 1982-1986

1. Penn Square Bank
Oklahoma City: July 5, 1982
Deposits: $470 million.

2. Oklahoma National Bank
Oklahoma City: Oct. 3, 1982
Deposits: $121 million.

3. Security State Bank (Woodward)
Mooreland: Dec. 16, 1982
Deposits: $10.1 million.

4. Bank of Red Oak (Latimer)
Dec. 16, 1983
Deposits: $10.5 million.

5. First Continental Bank and Trust Co.
Del City: May 11, 1984
Deposits: $94.3 million.

6. Community Bank (Garfield)
Enid: Sept. 14, 1984
Deposits: $28 million.

7. Security State Bank (Custer)
Weatherford: Sept. 20, 1984
Deposits: $40 million.

8. Farmers and Merchants Bank (Pottawatomie)
Tecumseh: Oct. 5, 1984
Deposits: $30 million.

9. American State Bank
Thomas: Oct. 19, 1984 (Custer)
Deposits: $21 million.

10. First National Bank
Marlow: Jan. 24, 1985 (Stephens)
Deposits: $27 million.

11. Farmers National Bank
Erick: Feb. 7, 1985 (Beckham)
Deposits: $16 million

12. Bank of Hunter (Garfield)
April 4, 1985
Deposits: $2.7 million.

13. Bank of Newcastle (McClain)
May 16, 1985
Deposits: $27 million.

14. First City Bank
Oklahoma City: June 21, 1985
Deposits: $85 million.

15. Crossroads State Bank
Oklahoma City: July 11, 1985
Deposits: $17 million.

16. Security Bank and Trust
Midwest City: August 8, 1985
Deposits: $35 million.

17. First National Bank
Terral: September 27, 1985
Deposits: $3.2 million

18. Bank of Canton
October 10, 1985
Deposits: $18.1 million

19. Farmers State Bank
Afton: October 17, 1985
Deposits: $9.5 million

20. First State Bank
Jet: October 18, 1985
Deposits: $11 million

21. Dill State Bank
Dill City: November 21, 1985
Deposits: $13.6 million

22. Farmers and Merchants National Bank
Hennessey: December 5, 1985
Deposits: $26.5 million

23. First State Bank
Cache: January 10, 1986
Deposits: $18 million

24. Elk City State Bank
February 21, 1986
Deposits: $21 million

Senator NICKLES. So we've got some problems, and I think the statistics show that we have some problems. The Farm Credit System last year, for the first time in its history, lost $2.79 billion. What can we do about it? Let me just offer a couple of recommendations for the committee to consider. And again, I appreciate the committee's indulgence.

First, Mr. Chairman, I would hope that we would look as far as the private banks, that we would give them the opportunity to be able to write off a loan loss over a period of years. I'm not sure exactly what that period of years should be, maybe 5 years, several years, 10 years. I'll leave that to the discretion and wisdom of this committee, but I think allowing the banks the opportunity to write those off over a period of years, instead of saying, yes, the auditor came in. He classifies that loan. It should be written off. Therefore, you're in a foreclosure procedure in many cases.

Oftentimes, you're displacing a farmer, a business person and maximizing the loss instead of minimizing the loss. I would hope if we had that deferral arrangement, where it could be written off over a period of time, that would give the banker and the farmer or rancher, the business person, the time and the flexibility to be able to work something out that would minimize those losses instead of increasing those losses. Minimize the number of displacements, foreclosures that we have in the System. I think it would give them some breathing room and some breathing room right now that we certainly need.

Second, Mr. Chairman, I think we will find that banks will be given some flexibility in maintaining their capital ratio. I propose that the present ratio which ranges from 5½ to 6 percent, be increased. In my State of Oklahoma, we had a bankers advisory meeting, where we had about 60 bankers in attendance from across the State, both large banks and small banks. We discussed the capital issue extensively. Many stated that while it might be a nice objective to have a higher capital ratio, implementing this at this time, where we're already in a very severe economic time, would be very, very detrimental to them. And they would find it very difficult to come up with additional requirements, and that would be putting additional pressure on financial institutions, at a time that they cannot stand that pressure.

Also, Mr. Chairman, I would hope that any financial institution would evaluate the benefit of restructuring a loan, as opposed to foreclosures. I would like to encourage banks—and most private banks are doing this, and we're encouraging FmHA to do this as well, to look at restructuring where possible, where that's cheaper than foreclosure. I've introduced legislation to do just this. We found that in the Farm Credit System, a lot of times the Federal land bank would implement and go forward with the foreclosure. For example, in a foreclose on an individual, the institution may only receive 50 percent of the original amount of the loan, where it might be much cheaper to restructure. This could be accomplished through deferral or possibly an interest rate or a principal reduction, maybe in the line of 20 percent. This would compare to a foreclosure loss of 50 percent which would and kick a farmer off his farm and then bring somebody else in at a lower rate.

The Farm Credit System in my State has interest rates right now of about 12¾ to 13¾ percent. We're finding that sometimes they'll foreclose. And we have 423 foreclosures in process right now in the Federal land bank system in our State. We have 2,000 that are behind on their payments. That's out of 18,000. To give you the statistics on the status of our Federal land bank system. What we're encouraging them to do, and we've introduced legislation that would basically require them to restructure if and when it is determined by a committee of their stockholder peers that it would be more economical to restructure than it would be to foreclose. I am trying to minimize the number of foreclosures, minimize the number of farmers and ranchers and business people that are thrown off of their property. It is cheaper to do that than a foreclosure.

Those are three recommendations this Senator has to offer. They are certainly not all-encompassing, and I am sure that the committee will come up with, hopefully, those, and it may be even others that will make some giant steps toward alleviating some of the very, very serious problems that we're finding in agricultural banks and energy banks throughout the country and particularly in States like mine.

I thank the chairman for his patience and also for his willingness to work with me and other Members to see if we can't solve some of these problems.

The CHAIRMAN. Thank you, Senator Nickles. Senator Melcher.

STATEMENT OF JOHN MELCHER, U.S. SENATOR FROM THE STATE OF MONTANA

Senator MELCHER. Mr. Chairman, members of the committee.

As we all know, Congress sets a national policy for American agriculture, periodically, with comprehensive farm bills and the most recent one passed was last December. It renewed agricultural policy for the country for 6 years.

Farmers want to get a price for their crops in the open market to cover their costs, plus, hopefully, a margin of profit, however, prices for grains, cotton, soybeans, and rice, as well as livestock and dairy prices at the market, are at or below the cost of production. With the exception of livestock, there are farm programs covering commodities that provide for price supports, and in addition, wheat, feed grains, cotton, and rice producers are provided with efficiency payments from the Treasury to protect their income while commodity prices are low. I believe, as agricultural producers believe, that the price supports set in this bill we just passed in December, are unwieldy mechanisms providing only a minimum safeguard for farmers and that the required restraints on production, also contained in the bill, may not cause commodity prices to recover in the open market.

DILEMMA OF LOW INCOME FOR FARMERS

In short, this bill just passed, like preceding farm bills, may not, over its life of 6 years, solve the dilemma of low farm income and cumulative large commodity surpluses, which are costly and require a Treasury deficiency payment. Yet that is the national goal,

and the bill itself is the underlying national policy. That is, first, to continue to produce large crops, most of which must be exported.

Second, it is national policy to maintain the present productive capacity. That means retaining, if possible, the current farm operation to produce a crop. Although restrained by provisions of the bill requiring farmers to set aside part of their land to reduce production, the crops that are expected to be harvested in 1986 will likely far exceed domestic needs and burden the market with continuing low prices.

Meanwhile, agricultural exports, which have declined 26 percent since 1981, are expected to increase over the next few years and strengthen commodity prices. Faced with a national policy of continued production of surplus commodities, the dilemma of farm operators is to survive 1986, and until stronger exports strengthen commodity markets, agricultural credit at lower rates of interest are desperately needed this spring.

Credit availability is generally from three sources, commercial banks, the Farm Credit System, and the Farmers Home Administration. Current interest rates run about an average of 13 percent on agricultural loans in commercial banks. Commercial banks have rigorously reviewed agricultural borrowers status and have classified approximately 20 percent of these loans. In general, over 50 percent of agricultural loans held by commercial banks are ranked as moderate-to-high risk and therefore, require high-interest rates.

The Farm Credit System has suffered losses in 1985 exceeding $2 billion and has set interest rates in some areas higher than 13 percent on farm operating loans. The Farmers Home Administration, the farm lender of last resort, has attempted to permit lower rates, but is still above 10 percent.

Interest costs for farm borrowers are, in most cases, the major operating cost. The rates are too high to show cash-flow capable of repaying the loans for the next 3 years, and it is crucial to have farm and ranch operating loans in the 8.5 to 9 percent range to permit adequate cash-flow, if 20 to 40 percent of current farm operators are to remain in business. While not every operator will be able to demonstrate a reasonable cash-flow at that rate of interest, a great number of those at risk could recover at a 4-percent lower rate of interest. Restructured loans at reduced rates will produce a positive cash-flow for many agricultural producers that will otherwise be unnecessarily liquidated.

In the farm bill, advance deficiency payments will be made to farmers in the corn, feedgrain, wheat, cotton and rice programs. That is some help for them, but the beef, pork, poultry, dairy, and other producers do not receive such payments. There can be no delays in this credit crunch to reduce interest rates, if the continuing syndrome of farm and ranch liquidations is to be stabilized. S. 2116 introduced by myself and Senators Burdick and Ford directs the Federal Reserve Governors to provide up to $36 billion in agricultural credit to commercial banks in the Farm Credit System at the rediscount rate now at 7 percent.

I've introduced amendments for S. 2116 to make it more workable. My approach does not add to the Federal deficit. Whatever we do here in Congress this year, we're going to be faced with the continuing requirement of not further adding to the Federal deficit without some offset. The Federal Reserve already has authority to provide this kind of credit assistance without new loss. The Federal Reserve System has used the discount window in this fashion in its early years.

In recent years, the Federal Reserve has restricted the use of the discount window to emergency situations and only provides a period of very short duration. I believe we have an emergency situation now with farm credit. I would hope we could convince the Federal Reserve that the agricultural credit crisis is a real emergency and that they would agree to act on their own; however, if the Federal Reserve cannot be convinced on the need to act quickly in this agricultural credit emergency, Congress must still find some solution to the dilemma we face.

Whatever methods are used, I believe a bill must be passed and implemented within a few weeks that will result in 8½ to 9 percent agricultural loans.

Mr. Chairman and members of the committee, I know your task to act quickly on measures that can provide such a type of interest rate reduction is a difficult one, but I urge you very sincerely to provide a method and a mechanism for relief very soon.

Thank you.

[The complete prepared statement follows:]

PREPARED STATEMENT OF SENATOR JOHN MELCHER

The national policy for American agriculture is periodically set by Congress in authorization of the comprehensive Farm Bill, which was only recently renewed for 6 years by Congress last December.

Farmers want to get a price for their crops in the open market that covers costs plus, hopefully, a margin of profit. However, prices for grains, cotton, soybeans, and rice, as well as livestock and dairy market prices are at or below the cost of production. With the exception of livestock, there are farm programs for commodities that provide for price support and, in addition, wheat, feed grains, cotton, and rice producers are provided with deficiency payments from the Treasury to protect their income while commodity prices are low.

I believe, as agricultural producers believe, that the price supports set in this bill are unwieldy mechanisms providing only a minimum safeguard for farmers, and that the required restraints on production may not cause commodity prices to recover on the open market.

In short, this bill just passed, like preceding farm bills, may not, over its life of 6 years, solve the dilemma of low farm income and cumulative large commodity surpluses, costly in Treasury deficiency payments.

Yet that is the national goal, and the bill itself is the underlying national policy. That is first to produce large crops, much of which must be exported and, second, it is national policy to maintain the present productive capacity. That means retaining, if possible, the current farm operations to produce the crops although restrained by provisions in the bill requiring farmers to set aside part of their land to reduce production, the crops harvested in 1986 will likely far exceed domestic needs and burden the market with continuing low prices. Meanwhile, agricultural exports, which have declined 26 percent since 1981, are expected to increase over the next few years and strengthen commodity prices. Faced with a national policy of continued production of surplus commodities, the dilemma of farm operators is to survive 1986 until stronger exports strengthen commodity markets. Agricultural credit at lower rates of interest are desperately needed.

Credit availability is generally from three sources: Commercial banks, the Farm Credit System, and the Farmers Home Administration.

Current interest rates run at about an average of 13 percent on agricultural loans.

Commercial banks have rigorously reviewed agricultural borrowers' status, have classified approximately 20 percent of those loans. In general, over 50 percent of agricultural loans of commercial banks are ranked as moderate-to-high risk and, therefore, require the high-interest rates. The Farm Credit System has suffered losses in 1985 exceeding $2 billion and has set interest rates in some areas higher than 13 percent on farm operating loans. The Farmers Home Administration, the farm lender of last resort, has attempted to permit lower rates, but is still above 10 percent.

The interest costs for farmer borrowers are in most cases a major operating cost, and the rates are too high to show cash flow capable of repaying the loans over the next 3 years.

It is crucial to have farm and ranch operating loans in the 8½ to 9 percent range to permit adequate cash flow if 20 to 40 percent of current farm operators are to remain in business. While not every operator will be able to demonstrate a reasonable cash flow at that rate of interest, a great number of those at risk could recover at a 4-percent lower rate of interest. Restructured loans at reduced rates will produce a positive cash flow for many agricultural producers that will otherwise be unnecessarily liquidated. In the farm bill, advance deficiency payments will be made to farmers in the corn, feed grain, wheat, cotton, and rice programs. That is of some help for them, but the beef, pork, poultry, dairy, and other producers do not receive such payments.

There can be no delays in reducing interest rates if the continuing syndrome of farm and ranch liquidations is to be stabilized.

S. 2116, introduced by myself, Senators Burdick and Ford, directs the Federal Reserve Governors to provide up to $36 billion in agricultural credit through commercial banks and the Farm Credit System at the rediscount rate, now at 7 percent. I have introduced amendments for S. 2116 to make this method workable to package.

This method does not impact the Federal budget.

The Federal Reserve already has authority to provide this kind of credit assistance without new law. While the Federal Reserve System has used the discount window in this fashion in its early years, in recent years the Federal Reserve has restricted the use of the discount window to emergency situations and only for periods of very short duration.

I would hope that we could convince the Federal Reserve that the agricultural credit crisis is a real emergency and that they would agree to act on their own. However, if the Federal Reserve cannot be convinced of the need to act quickly in this agricultural credit emergency, we will see thousands more ranchers and farmers needlessly driven out of business.

Whatever methods are used, I believe a bill must be passed and implemented within a few weeks that will result in 8½ to 9 percent agricultural loans.

The CHAIRMAN. Thank you, Senator Melcher.

Senator Exon.

STATEMENT OF J. JAMES EXON, U.S. SENATOR FROM THE STATE OF NEBRASKA

Senator EXON. Thank you very much, Mr. Chairman. Mr. Chairman and members of the committee, thank you for having us here this morning to address firsthand the problem.

We are just delighted that you are moving aggressively ahead in this area.

Mr. Chairman, I will read from a rather brief statement. I think that is a lot better than going off the cuff.

Significant numbers of agricultural lenders face serious problems because of high-interest rates, the high value of the dollar, the low farm income, and the declining land value. It is just scary when you are out there seeing it firsthand.

In the last 3 years, 22 banks have closed in Nebraska. The depressed agricultural economy has been a major factor in most of

these closings. It is not only the farmers and the ranchers, Mr. Chairman, it is the Main Street businessmen who are now experiencing bankruptcies at the highest rate since the Great Depression.

We must do something now because the situation in the Farm Belt is critical. Just last Thursday the Federal regulators closed the First National Bank of Tekemah.

As a result of these closings, hundreds of farmers and ranchers now must deal with the FDIC on their outstanding loans rather than with their local banker.

Across the Nation agricultural bankers face the difficult choice of foreclosing on farms or risking their own liquidation or forced merger with the bank regulations as they presently exist.

Mr. Chairman, I am encouraged by your commitment to move quickly on legislation to address these problems. I would suggest that this committee and the Senate consider each of the three specific proposals that have been made, identified by the general task force of the American Bankers Association and the Independent Bankers Association of America.

These three areas include measures to stabilize the capital position of the agricultural lenders, programs to improve the position of the farm borrowers, and steps to address the declining farmland value.

With regard to bank capital, I was very interested to read the report issued last month by the FDIC on farm bank problems. That report was the first public acknowledgement that I have seen from the bank regulatory agencies that there are indeed serious problems in rural America.

PROGRAMS TO ASSIST TROUBLED FARMERS

The report discussed two possible alternatives for improving the capital position of farm banks, a Net Worth Certificate Program or a Loss Deferral Program.

I introduced legislation last year, as the chairman and others know, to extend the Net Worth Certificate Program to distressed agricultural lenders.

My distinguished colleague from Illinois, Senator Dixon, has introduced legislation to permit farm banks to amortize their loan losses over a period of 10 years, and I strongly support that legislation.

The FDIC report concluded, and I quote:

> A carefully constructed program that enabled farm banks to defer or be reimbursed for some portion of their losses could help reduce the number of bank failures and limit further disruption to the farm community.

I would urge the committee to approve a Net Worth Certificate Program, a Loss Deferral Program, or some combination of the two to address the capital problem of farm banks.

With regard to improving the position of the agricultural borrower, I would recommend expansion of the $490 million Interest Buydown Program which was included in the new farm bill, as well as other guarantee programs with the Farmers Home Administration.

I believe it is essential that any package developed by the Congress provide direct assistance to farm borrowers as well as their local banks.

Finally, the Congress must address the problem of declining land values. In many parts of my State, the value of farm land has dropped as much as 50 percent and in some cases more over the last 5 years. You can imagine, members of the Banking Committee, what that does to financial statements.

Several options have been presented to you, including a secondary market for farm real estate and permitting banks to hold agricultural land for longer periods of time.

As the recent FDIC report noted, in some instances it may be preferable for a bank to lease land back to farmers rather than selling it.

Senator Nickles addressed that in his testimony that preceded mine. I associate myself with the remarks that Senator Nickles made in this regard.

Mr. Chairman, I look forward to reviewing the testimony that was presented to the committee today by the Federal regulators. I don't believe they have given the small farm lenders the same consideration as they give to institutions which are too large to fail.

I was shocked to read over the weekend that the FDIC has lost $1.3 billion on its bailout of a single bank, Continental Illinois' National Bank of Chicago. The apparent double standard that exists in bank regulation must come to an end.

Several of the bank failures in my State left their community without a financial institution. While those closings did not affect the Nation's banking system, they definitely affected the families and the businesses in those communities.

I am hopeful that the regulators will have a specific recommendation or program that they could put in place immediately to address this problem. If that is the case, I urge those agencies to act at once.

I would remind them of the remarks of President Reagan in his State of the Union address when he noted that "Farmers must not be abandoned with problems they did not create and cannot control."

In addition to any regulatory changes, I believe it is absolutely essential that Congress act in a timely manner to assist agricultural lenders and their customers. We have provided special assistance to the Farm Credit System as well as the savings and loan industry. Farm banks and their customers deserve the same consideration.

I stand ready to work with you to meet these important and critical challenges.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Exon.

Gentlemen, we are pleased that you would take the time to be with us. We have had six or seven of our colleagues, as you point out, particularly from the States that are the most impacted, the Farm Belt.

We appreciate your coming. We will try to move as expeditiously as possible. At this point I can't tell you what the legislation might look like.

I will repeat, I hope we can achieve a consensus on the committee so that we can move as rapidly as possible.

Senator Cranston.

Senator CRANSTON. Thank you very much. I have no opening statement.

I would like to welcome Preston Martin, the distinguished Governor of the Federal Reserve System.

Senator EXON. Most Senators are interested in constituents during an election year. [Laughter.]

The CHAIRMAN. Senator Hecht, do you have any comments or questions you want to make?

Senator HECHT. No, thank you, Mr. Chairman.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. No.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. No. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, gentlemen.

Next, I would like to invite William Seidman, Chairman of the Federal Deposit Insurance Corporation; Robert Clarke, Comptroller of the Currency; and Preston Martin, Vice Chairman of the Federal Reserve System. Governor Martin is accompanied by William Taylor, Director of the Division of Banking Supervision and Regulation.

Mr. Seidman, would you like to begin, please?

STATEMENT OF L. WILLIAM SEIDMAN, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. SEIDMAN. Thank you, Mr. Chairman, members of the committee. I am pleased to have the opportunity to come before the Senate Banking Committee to discuss farm bank problems and policy options.

The FDIC submitted a report entitled "Farm Bank Problems and Related Policy Options" to the Senate Banking Committee on February 18. As requested, the report provided an assessment of current conditions and the outlook for agricultural producers and banks as well as a discussion of related policy options.

Today I would like to briefly review the prospects for farm banks and provide a specific set of recommendations to assist troubled farm banks.

For many of the banks that support the farm sector, it is becoming increasingly difficult to withstand the pressures created by the adverse developments in the agricultural sector during the past 5 years.

There are close to 4,000 banks that have 25 percent or more of their loan portfolios in farm loans. This represents about 28 percent of all commercial banks. Most of these banks are located in the Midwest and Great Plains States and are typically small, with total assets equal to only about 4 percent of all commercial bank assets.

While there were only 7 agricultural bank failures in 1982 and 7 more in 1983, there were 25 in 1984 and an additional 62 bank failures this past year.

Current trends suggest that at least for the next year farm bank problems and failures are likely to continue at levels at least equal to those experienced during 1985.

While profitability has been trending down for small banks in general, it has been falling more rapidly in agricultural banks. Net losses of agricultural banks nearly tripled over the past 2 years.

468 FARM BANKS ON PROBLEM LIST

Presently, the FDIC's problem list includes 468 farm banks, about 40 percent of the total for commercial banks. Despite this, there are a number of positive signs.

The aggregate primary capital ratio for agricultural banks is about 10 percent, roughly equivalent to what it was 2 years ago and well above that of other small banks.

Moreover, most farm banks are performing well, and only about 1 percent of all farm banks have a primary capital ratio below 6 percent.

A number of suggestions have been offered to ease the strain on agricultural banks. Net worth certificates, interest rate buydowns, Loss Deferral Program, and forbearance and regulatory capital standards are among the policy options that have been suggested.

The FDIC is sympathetic to the motives behind these proposals. Most of the options are designed to buy time for participating institutions to resolve the problems created by a weak farm economy.

But one must keep in mind that the basic problem faced is one of the difficult conditions of the agricultural economy, not a banking problem. The banks may provide some short-term limited aid, but only a return to prosperity for the farmer can bring a cure.

We must exercise care that we do not create a banking system problem because of the difficulties in the agricultural or other sectors.

A carefully constructed program that enables farm banks to defer or be reimbursed for some portion of their losses could reduce the number of farm bank failures, increase credit availability to farmers, and limit further disruption to farm communities. Farmers could benefit, since banks would have a greater incentive and ability to exercise forbearance with their troubled borrowers.

As the number of farm bank failures declined, there would be fewer instances where creditworthy borrowers would be forced to look for new lending institutions and fewer instances where local residents would be left without banking service.

There also could be some positive effect on public confidence in the banking system.

A significant drawback, however, is that there are potentially large costs associated with loss deferral and similar programs designed to aid troubled banks. Some portion of these costs would be administrative, since a substantial number of banks may be candidates for assistance over the next 2 years.

However, the greater concern relates to the ultimate cost of any relief program should economic conditions not improve sufficiently over the next several years to allow the marginal banks and borrowers sufficient opportunity to return to profitability. Relief programs may only delay failures, and our experience suggests that delay results in larger losses to the FDIC insurance fund.

There are also equity considerations. How does one justify giving special treatment to banks that have financial difficulties due to

agricultural problems when other financial institutions are suffering from problems due to weakness in other areas of the economy.

A longer run issue concerns the precedent we would be setting. There may be an incentive for increased risk taking if we assist banks that have difficulties as a result of lending to certain sectors of the economy.

Also, it may be difficult to maintain the credibility of our accounting and supervisory standards. In this regard, I am pleased to point out that a part of the solution actually may be found with tools already available to banks under generally accepted accounting standards.

GAAP provides for considerable flexibility with respect to loss recognition of restructured loans. Statement of Financial Accounting Standard 15 [FASB-15] for accounting by debtors and creditors for troubled debt restructuring provides for deferral by allowing reduced value to be recognized through future interest payments, and I give you an illustration, which I won't go through.

Under this method loans may be restructured. Principal payments can be made over an extended period and interest rates reduced. Loans can be repaid without requiring any immediate write-offs. Income loss is recognized through reduced interest income.

For loans that meet FASB standards, the impact on the lending bank is very similar to loss deferral. This option should be made available to all banks, and as indicated, its use conforms to generally accepted accounting standards.

In the past this has not been the uniform practice of the bank regulators and especially the FDIC. I have instructed FDIC examiners and urge that all Federal bank examiners be instructed to accept the FASB-15 concept in classifying loans so long as they are comfortable with respect to the ultimate collectibility of such a restructured loan.

Separately, we have been looking at the way we require renegotiated loans to be reported. This is an area that has been of concern to many agricultural bankers.

FAVOR REVISING REPORTING REQUIREMENTS

We favor revising reporting requirements on such loans and setting up a separate reporting category, restructured and in compliance with modified terms. This will require a uniform approach by all bank regulators.

In certain situations where the economic environment accounts for most of a bank's difficulties, some form of capital forbearance may be appropriate in addition to the effect of the application of FASB-15. Various approaches are possible.

The Loan Loss Deferral Program and the use of net worth certificates provide means of avoiding bank capital requirements by maintaining book capital. The same result can be accomplished simply by allowing a bank's capital to fall below minimum standards without taking enforcement actions.

Banks may be given longer than usual to restore capital. This form of forbearance is simpler than net worth certificates and loss deferral, and it does not involve the administrative burden of net worth certificates or the accounting variance of loss deferrals.

However, as bank capital levels decline, so will loan limits to single borrowers, and at some point this could pose a problem.

Simply put, each of the capital forbearance approaches have certain disadvantages that must be considered.

Perhaps the simplest approach, if one looks for a way to create capital on the books, would be to create an election for banks to charge loan losses to a special allowable capital account which would then be amortized over a period of time, perhaps 5 years. The special capital account would be similar to a bad debt reserve account but could be used as capital only when necessary to create required capital levels or to provide a single borrower capital capacity.

The same thing would be done by simply keeping a memo account off the banks, and that would probably be preferable.

The combination of FASB–15 and, when appropriate, capital forbearance could provide considerable latitude to weakened farm banks that have a good chance of surviving. Such policies could also go far in continuing to provide financing to farm borrowers and limiting disruptions in the farm community.

Whatever policies are eventually chosen by the regulators or the Congress, it is likely that there will continue to be some failures among farm banks.

Much of the disruption to the farm community that results from bank failures could be reduced if ways were found to ensure that a failed bank's customers would continue to receive bank service.

MODIFIED PROCEDURES IN HANDLING BANK FAILURES

It is our intention to continue with our efforts to reduce these disruptions by modifying our procedures with respect to the handling of bank failures. Whenever possible, the FDIC will attempt to find purchasers of failed banks and limit the number of deposit payoffs or liquidations.

We will also pursue avenues which will enable us to pass the larger portion of a failed bank's assets on to the acquiring bank. It is our view that such efforts can limit many of the secondary effects of bank failures and can be accomplished at modest costs.

I will be pursuing this matter with you in more detail when deposit insurance reform is the subject of the day.

We also believe that individual States in the farm sector should take a close look at their branching laws and their laws governing the disposal and evaluation of real estate acquired by commercial banks. More liberalized branching laws would enable banks to achieve greater diversification and would help banks avoid future difficulties due to weakness in a particular sector of the economy.

Liberalizing the laws governing the disposal and evaluation of real estate acquired by commercial banks may ease some transition costs by allowing banks to lease land back to farmers rather than selling it and putting an additional downward pressure on land prices.

To summarize, the FDIC makes the following recommendations:

Banks should be allowed to account for modification of loan terms as reduced income. Thus, no loss will be recorded at the time

of restructuring. Such treatment is in accordance with the Statement of Financial Accounting Standard 15.

Banks should be allowed changed disclosure requirements for renegotiated loans. Federal regulators should recognize the special nature of farm problems and in appropriate situations some form of capital forbearance is desirable.

The States should be encouraged to liberalize overly restrictive branching laws and to examine the permissible periods for holding real estate.

I would conclude by saying that the regulators have been meeting on this subject, and we have agreed on a statement encompassing the general principles herein, which we will submit at the end of the oral presentations.

Thank you.

[The complete prepared statement follows:]

STATEMENT ON

FARM BANK PROBLEMS AND POLICY OPTIONS

PRESENTED TO

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
UNITED STATES SENATE

BY

L. WILLIAM SEIDMAN
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

Room SD-538, Dirksen Senate Office Building
March 11, 1986
9:30 a.m.

Mr. Chairman, I am pleased to have the opportunity to come before the Senate Banking Committee to discuss farm bank problems and policy options. The FDIC submitted a report entitled, "Farm Bank Problems and Related Policy Options" to the Senate Banking Committee on February 18. As requested, the report provided an assessment of current conditions and the outlook for agricultural producers and banks, as well as a discussion of related policy options. Today, I would like to briefly review the prospects for farm banks and provide a specific set of recommendations to assist troubled farm banks.

For many of the banks that support the farm sector it is becoming increasingly difficult to withstand the pressures created by the adverse developments in the agricultural sector during the past five years. There are close to 4,000 banks that have 25 percent or more of their loan portfolios in farm loans. This represents about 28 percent of all commercial banks. Most of these banks are located in the Midwest and Great Plains states, and are typically small, with total assets equal to only about four percent of all U.S. commercial bank assets. While there were only seven agricultural bank failures in 1982 and seven more in 1983, there were 25 farm bank failures in 1984 and an additional 62 agricultural bank failures this past year.

Current trends suggest that, at least for the next year, farm bank problems and failures are likely to continue at levels at least equal to those experienced during 1985. While profitability has been trending down for small banks in general, it has been falling more rapidly at agricultural banks. Net loan losses at agricultural banks nearly tripled over the past two years.

Presently, the FDIC's problem bank list includes 468 farm banks, about 40 percent of the total for commercial banks.

Despite this, there are a number of positive signs. The aggregate primary capital ratio for agricultural banks is about 10 percent, roughly equivalent to what it was two years ago, and well above that of other small banks. Moreover, most farm banks are performing well and only about one percent of all farm banks have a primary capital ratio below six percent.

A number of suggestions have been offered to ease the strain on agricultural banks. Net worth certificates, interest rate buydowns, loss deferral programs, and forbearance on regulatory capital standards are among the policy options that have been suggested. The FDIC is sympathetic to the motives behind these proposals. Most of the options are designed to buy time for participating institutions to resolve the problems created by a weak farm economy.

But one must keep in mind that the basic problem faced is one of the difficult conditions of the agricultural economy, not a banking problem. The banks may provide some short-term and limited aid, but only a return to prosperity for the farmer can bring a cure. We must exercise care that we do not create a banking system problem because of the difficulties in the agricultural or any other sector.

A carefully constructed program that enables farm banks to defer or be reimbursed for some portion of their losses could help reduce the number of farm

bank failures, increase credit available to farmers and limit further disruptions to farm communities. Farmers would benefit since banks would have a greater incentive and ability to exercise forbearance with their troubled borrowers. As the number of farm bank failures declined, there would be fewer instances where creditworthy borrowers would be forced to look for new lending institutions and fewer instances where local residents would be left without banking services. There also could be some positive effect on public confidence in the banking system.

A significant drawback, however, is that there are potentially large costs associated with loss deferral and similar programs designed to aid troubled banks. Some portion of these costs would be administrative, since a substantial number of banks may be candidates for assistance over the next two years. However, the greater concern relates to the ultimate costs of any relief program should economic conditions not improve sufficiently over the next several years to allow the marginal banks and borrowers sufficient opportunity to return to profitability. Relief programs may only delay failures and our experience suggests delay results in larger losses to the FDIC insurance fund.

There are also equity considerations. How does one justify giving special treatment to banks that have financial difficulties due to agricultural problems when other financial institutions are suffering from problems due to weaknesses in other areas. A longer-run issue concerns the precedent we would be setting. There may be an incentive for increased risk-taking if we assist banks that have difficulties as a result of lending to certain sectors of the economy.

Also, it may be difficult to maintain the credibility of our accounting and supervisory standards.

In this regard, I am pleased to point out that a part of the solution actually may be found with tools already available to banks under generally accepted accounting standards. GAAP provides for considerable flexibility with respect to loss recognition of restructured loans. The Statement of Financial Accounting Standards #15 for Accounting by Debtors and Creditors for Troubled Debt Restructurings provides for deferral, by allowing reduced value to be recognized through future interest payments. Let me illustrate: A three-year $1,000 12 percent loan is renegotiated as an $800 five-year 10 percent loan (total payment is 5 x 80 = $400 + $800 = $1200). No loss is reported and the $200 of payment over the original principal is reported as interest received over five years. Thus, this method facilitates restructuring loans. Principal payments can be made over an extended period and interest rates reduced. Loans can be repaid without requiring any immediate writeoffs. Income loss is recognized through reduced interest income. For loans that meet FASB standards, the impact on the lending bank is very similar to loss deferral. This option should be made available to all banks and, as indicated, its use conforms to generally accepted accounting standards. In the past this has not been the uniform practice of bank regulators, and especially the FDIC. I have instructed FDIC examiners, and urge that all Federal bank examiners be instructed, to accept the FASB #15 concept in classifying loans so long as they are comfortable with respect to the ultimate collectibility of such restructured loans.

Separately, we have been looking at the way we require renegotiated debt to be reported. This is an area that has been of concern to many agricultural bankers. We favor revising reporting requirements on such loans and setting up a separate reporting category, "Restructured and In Compliance With Modified Terms." This will require a unified approach by all bank regulators.

In certain situations, where the economic environment accounts for most of a bank's difficulties, some form of capital forbearance may be appropriate in addition to the effect of the application of FASB #15. Various approaches are possible. Loan loss deferral programs and the use of net worth certificates provide means of avoiding bank capital requirements by maintaining book capital. The same results can be accomplished simply by allowing a bank's capital to fall below minimum requirements without taking enforcement actions. Banks might be given longer than "usual" to restore capital. This form of forbearance is simpler than net worth certificates and loss deferral. It does not involve the administrative burden of net worth certificates or the accounting variance of loss deferral. However, as bank capital levels decline so will loan limits to single borrowers and, at some point, this could pose a problem. Simply put, each of the capital forbearance approaches have certain disadvantages that must be considered.

Perhaps the simplest approach would be to create an election for banks to charge loan losses to a special allowable capital account which would then be amortized over a period of time (perhaps five years). The special capital account would be similar to a bad debt reserve account but could be used as

capital only when necessary to create required capital levels or to provide needed single-borrower capital capacity. The combination of FASB #15 and, when appropriate, capital forbearance could provide considerable latitude to weakened farm banks that have a good chance of surviving. Such policies could also go far in continuing to provide financing to farm borrowers and limiting disruptions in the farm community.

Whatever policy options are eventually chosen by regulators or the Congress, it is likely that there will continue to be some failures among farm banks. Much of the disruption to farm communities that results from bank failures could be reduced if ways were found to ensure that a failed bank's customers continued to receive banking services. It is our intention to continue with efforts to reduce these disruptions by modifying our procedures with respect to the handling of bank failures. Whenever possible, the FDIC will attempt to find purchasers of failed banks, limiting the number of deposit payoffs. We will also pursue avenues which may enable us to pass a larger portion of a failed bank's assets on to an acquiring bank. It is our view that such efforts can limit many of the secondary effects of bank failures and can be accomplished at modest costs. I will be pursuing this matter with you in more detail when deposit insurance reform is the subject of the day.

We also believe that individual states in the farm sector should take a close look at their branching laws and their laws governing the disposal and valuation of real estate acquired by commercial banks. More liberalized branching laws would enable banks to achieve greater diversification which would help banks

avoid future difficulties due to weakness in a particular sector of the economy. More immediately, liberalized branching laws would help limit the disruptions to farm communities caused by bank failures by increasing the likelihood that a failure could be handled by merger rather than through a deposit payoff. Restrictive branching laws cost the FDIC's insurance fund money and perhaps additional premiums should be charged to compensate the fund and encourage changes in state laws.

Liberalizing the laws governing the disposal and valuation of real estate acquired by commercial banks may ease some transition costs by allowing banks to lease land back to farmers, rather than selling it and putting an additional downward pressure on land prices.

To summarize, the FDIC makes the following recommendations:

- Banks should be allowed to account for modifications of loan terms as reduced income. Thus, no loss will be recorded at the time of restructuring when such treatment is in accordance with the Statement of Financial Accounting Standards #15 for Accounting by Debtors and Creditors for Troubled Debt Restructurings.

- Banks should be allowed changed disclosure requirements for renegotiated loans, providing an accurate description of their status.

- Federal regulators should recognize the special nature of farm problems and that, in appropriate situations, some form of capital forbearance is desirable.

- The states should be encouraged to liberalize overly restrictive branching laws thereby increasing the likelihood that weak banks will be merged or otherwise acquired by healthier institutions.

- The states should be encouraged to examine the permissible period that banks may hold farm real estate to help preserve value and limit forced sales of such property into a weak market.

- For its part, the FDIC will continue to pursue policies that will minimize the disruption in the community and the cost to the insurance fund of bank failures.

The CHAIRMAN. Thank you very much.
Mr. Clarke.

STATEMENT OF ROBERT L. CLARKE, COMPTROLLER OF THE CURRENCY

Mr. CLARKE. Thank you, Mr. Chairman.
This is the first time I have testified before this committee and spoken into two microphones, which I guess underscores the importance of the subject here today.

UNCERTAIN CONDITIONS IN AGRICULTURAL ECONOMY

I welcome this opportunity to appear before you to discuss the problems being experienced by agricultural banks and to propose some solutions. As you are well aware, the American agricultural economy continues to experience severe difficulties. Farm incomes and asset values, particularly the price of farm land, continue to decline, weakening the financial condition of highly leveraged farmers and putting pressure on agricultural lenders.

Agricultural banks must continue to adjust to the changing and uncertain conditions in agriculture. However, the problems faced by agricultural banks will ultimately be eliminated only when the agricultural problem itself is eliminated—a process that may take several years, depending, among other things, on the future strength of export markets and the level of real interest rates.

This morning I would like to provide some background information on agricultural banks and describe what actions our Office is considering to assist agricultural banks in making the needed adjustments. Then I will discuss additional measures that could be taken by the Congress, the States, and the banks themselves to ensure that this adjustment is as smooth and painless as possible for both lenders and farm borrowers.

Agricultural banks, defined as banks with over 25 percent of gross loans in agricultural credits, number 3,900—roughly a quarter of all commercial banks. These banks hold about half of the $50 billion in commercial bank credit to the farm sector, and their total assets constitute approximately 5 percent of the total $2.6 trillion in commercial bank assets. They are located mostly in the Midwestern States. The median agricultural bank is only one-half the size of the median nonagricultural bank.

As of yearend 1982, only 1 percent of national agricultural banks were problem banks. However, as of December 1985, 12 percent of all national agricultural banks, 102 of them, were problem institutions. Of the 30 national banks that failed in 1985, 10 were agricultural banks.

We believe that a significant majority of agricultural banks have sound prospects for the future. Many of these banks possess strong management that has insisted on adhering to sound lending practices. As a result, most agricultural banks hold significant amounts of capital and are continuing to generate earnings that equal or exceed those of other comparably sized commercial banks.

This is not to suggest that there is no problem. For the banks that fail, the consequences are traumatic—for their employees, their shareholders, and the communities they serve. Moreover, the

magnitude and severity of the problem has been made clear to us through our frequent meetings with national and State agricultural bankers. Two weeks ago, the chief national bank examiner and three of our senior staff members visited a number of States in the Farm Belt. From these meetings and from our own data we recognized that among even the better managed agricultural banks many are under financial strain.

However, we are optimistic that the bulk of the agricultural banking sector possesses the resources, management, talent, and willingness to work with their borrowers going forward, and we believe that efforts should be directed toward finding ways to strengthen and assist them during this difficult period.

It is our view that the most beneficial thing we can do for these banks is to identify and remove obstacles that inhibit banks from successfully helping themselves and their borrowers. It is only by identifying their losses and restructuring credits to reduce farmers' debt burdens that agricultural banks will be able to put their problems behind them and improve the quality of their loan portfolios.

Although such restructuring would be in the long run best interest of banks and their borrowers, many banks have been reluctant to write down loans or grant other concessions to borrowers because of the effect this might have on their capital levels. In particular, banks fear that reduced capital levels could prompt regulators to direct them to make immediate increases in capital. In addition, they are reluctant to reduce capital because of the lower lending limit that would result.

FASB–15 AS A TOOL

The three Federal bank regulatory agencies have been considering for some time a variety of ways that banks could be given the tools and the encouragement to effect long-term restructuring of problem credits. Among the options are the following, none of which requires legislative action and all of which could be implemented by regulatory decisions.

First, banks could be encouraged to understand and use the provisions of Financial Accounting Standards Board Statement No. 15 to account for restructured debt. This is a procedure that Chairman Seidman just discussed. This accounting approach can, under certain circumstances, be used to account for concessions in financing terms, for example, the reduction of either principal or interest which is granted to borrowers experiencing financial difficulty without requiring the institution to record any losses. FASB–15 has not been readily used in the past. Many bankers simply have not been aware of its existence. Moreover, it is, at least on the surface, somewhat complicated. Finally, it is of limited use in situations where an actual credit loss has occurred.

Nevertheless, it is available in the right situations, and we would propose calling it to the attention of bankers by reiterating the manner in which it can be used. It is a useful device. I have included in my written statement an example of how it would work.

Second, we would propose modification of the present call report disclosure requirements for restructured loans to allow banks to distinguish those loans that, although restructured, are in compli-

ance with the new terms. Under this proposal, such restructured loans would no longer be included in the category of nonperforming loans. Such a change would require revision of the call report, which we are prepared to initiate immediately.

Third, and perhaps most importantly, we are considering the option of capital forbearance that we believe will encourage banks to write down problem loans and develop workout plans. The essence of this option is to encourage agricultural banks to recognize losses, but allow them to operate temporarily with lower levels of capital.

Capital forbearance, which is really a variation on loan loss deferral plans—but a better one we think—would would permit banks to place a portion of their agricultural loan chargeoffs into a segregated account. The amount in the segregated account could not exceed some percent of the bank's primary capital. Additions to the segregated account could be made during the first 2 years after implementation of the policy. The segregated account would then be amortized in equal increments during the 5 years immediately following the addition to the account. Thus, the segregated account would exist for a maximum of 7 years. I have included an example of how this option could be utilized in my written statement.

We believe capital forbearance would be responsive to the needs of agricultural banks and their borrowers during a difficult period of transition for a number of reasons. First, it is our hope that it will encourage banks to take advantage of the Farmers Home Administration Debt Adjustment Program. Participation in the Debt Adjustment Program has been limited, at least in part, because of the reluctance of banks to write down loans and suffer the immediate diminution of capital. Under the capital forbearance option, the writedown could qualify the loan for the Debt Adjustment Program, but would not trigger a regulatory response for more capital.

Another attractive feature is that capital forbearance will primarily benefit agricultural banks that, after the chargeoffs, will then be able to generate sufficient earnings to replenish their capital. This option does not, however, provide any support to those banks that have completely exhausted their capital, nor would it assist banks that have little or no prospect of returning to profitability. While these banks would continue to receive our supervisory efforts toward recovery, any special assistance might serve to simply prolong their difficulties without improving their prospects for recovery, thus raising the potential liability to the FDIC.

There are also administrative advantages to capital forbearance. It requires no statutory change. Although it initially specifies a 7-year timeframe, we would have the flexibility to extend it if conditions so warrant. It is easily understandable and self-executing, which means that bankers can enjoy the benefits immediately rather than making an application to the regulator and waiting for a response. Finally, it utilizes existing programs and would not represent significant increased resource costs to the banking agencies.

CAPITAL FORBEARANCE AS SUPERIOR

We view capital forbearance as superior to other transitional assistance devices that have been suggested because it would accom-

plish the same end, but, avoid several adverse consequences that are inherent in the other proposals. Loan loss deferrals are a case in point. Loan loss deferrals would permit a bank to write down the loss portion of a problem loan over an extended period of time rather than all at once. Because the deferred writedowns would temporarily qualify as capital, they, in effect accomplish the same thing as capital forbearance; that is, they permit a bank to operate with a weaker capital position than normally required by the regulator.

However, a loan loss deferral plan, unlike capital forbearance, would distort the bank's financial statements. It would result in a misleading report of a bank's net income and shareholders' equity because identified losses would not be accurately reflected. In our view, this is a serious shortcoming. The advantage of the capital forbearance option that we are advancing is that losses are recognized when they occur and clear disclosure can be made to the reader of the bank's financial statements as to the transitory nature of the segregated account—yet banks still receive the needed time to bring their capital back to historical standards. Thus, the integrity of financial statements would be preserved so that neither shareholders nor the general public would be misled about the bank's financial condition.

The loan loss deferral plans that have been proposed may be flawed in another respect as well. They may encourage agricultural banks to postpone dealing with their problems by allowing an extended period of time for loan loss amortization. The capital forbearance option, on the other hand, would operate within a shorter time horizon to enable agricultural banks to confront their problems more immediately, resulting in earlier identification of losses and restructuring of loans.

Capital forbearance is also superior to simply lowering capital requirements on a case-by-case basis. A simple lowering of capital requirements would result in a parallel decline in the bank's lending limit—posing problems for both borrowers and lenders in renewing and restructuring loans. Amending the lending limit requirement to correct this problem would then require statutory revision. Under the capital forbearance option, however, the segregated account containing the agricultural loan losses could be counted toward capital for lending limit purposes. Also, unless capital requirements were lowered across the board, which would also require a lengthy regulatory change, banks being dealt with on a case-by-case basis would not know what kind of regulatory response to expect as they write down loans. The capital forbearance option has none of these disadvantages since it applies equally to all agricultural banks and requires no application process.

Although we believe that capital forbearance will help agricultural banks deal with their current problems, it does nothing to mitigate the underlying causes of problems faced by agricultural banks. Those banks will need strong earnings to replenish their capital and to ensure their long-run survival beyond the current downturn in the agricultural economy.

In our view, the most important thing agricultural banks can do to improve their ability to withstand future downturns in the farm sector is to diversify their assets. Some of the concentrated portfo-

lios in agricultural banks resulted from conscious decisions by bank owners and management. Others are attributable to factors beyond their control. Among those are restrictions on geographic expansion and on loan sales and purchases.

Principal among geographic constraints are State-law limitations on intrastate branching and prohibitions against interstate multibank holding companies. Those constraints often make it difficult for banks in agricultural areas to diversify their loan portfolios. Geographic restrictions also have particular impact in the case of failing or failed banks. Finally, geographic restrictions prevent banking services from being provided in the most efficient manner possible.

In light of these problems, we encourage States with restrictive intrastate branching laws to consider changing these laws to open new opportunities for lending to agricultural banks and to facilitate the evolution of economically efficient banking structures. We also encourage Congress to consider amending the emergency acquisition provisions of the Garn-St Germain Act of 1982 by reducing the eligible asset size and allowing the acquisition of the entire holding company of a troubled bank rather than just the bank.

States should also be encouraged to remove prohibitions on farm ownership that limit the market. Our office has responded to this problem by generally allowing national banks to hold farm land acquired through foreclosure for as long as 10 years, which is the maximum allowed by law. As a result, these banks are not forced to put real estate on the market at an inopportune time, which could further depress farmland prices.

NEED TO DIVERSIFY

If agriculture banks are to continue to serve adequately their farming communities and avoid the problems in which they find themselves today, they need to increase the diversification of their borrower base. However, this may be difficult for a number of agricultural banks, particularly those in States where agriculture and related industries dominate the economy. The larger regional and multinational banks can originate loans nationwide and thereby lend to a variety of industries, but it is virtually impossible for smaller banks to achieve the same level of diversification.

Although the acquisition of loan participations is one way for banks to diversify their portfolios, there are some obstacles that particularly impact the smaller community banks. Glass-Steagall prohibitions against commercial bank underwriting of securities mean that loan participations must be carefully structured, thus limiting their usefulness for small banks.

If smaller banks are to become active participants in the market for loan sales and purchases, such loans will have to be converted into securities that can be freely transferred among investors.

Before such a market can be developed for either shares of whole loans or loan pools, however, Federal law must be changed to permit national banks to underwrite the sale of interests in pools of loans and to participate in private placements.

Not all of the impediments to banks forming and selling security interests in loan pools are the result of legal constraints. One issue

that can be addressed through regulatory action involves structuring securities so that the purchasing bank has certain protections against default by the underlying borrowers, while allowing the pooling bank to remove the pooled loans from its books for reporting purposes. In conjunction with banks that have presented loan pooling proposals, our Office is developing procedures to deal with this and a number of other issues.

While actions by the Congress, the States, and bank supervisors would certainly ease the transition agricultural banks need to undergo, their long-term survival requires that agricultural banks themselves take several actions. First, as we have outlined in guidelines issued to national banks, they should review the effectiveness of their lending policies. In addition, agricultural banks should make an effort to reduce their reliance on the agricultural sector. They should continue to work with their local communities in attracting new industries and take advantage of opportunities for asset diversification as they become available.

As I indicated in my testimony last week before this committee, the failure to modernize banking statutes has prevented many banks from reducing their reliance on lending. Product limitations have also made it difficult for banks to seek alternative sources of income as their traditional activities have become less profitable. While such expanded activities have often been viewed as helping primarily large institutions, there is a tremendous opportunity for small banks to act as brokers in offering financial products such as mutual funds, or to enter into joint ventures with other banks for the delivery of these products. New opportunities for diversification of assets and income sources will make banks less susceptible to any future problems in the agriculture industry.

In conclusion, we believe the regulatory policies inherent in our proposals today will provide agricultural banks with incentives and the time needed to address asset quality problems in a thoughtful and orderly manner, meeting the needs of the borrowers they serve and helping to rehabilitate both the borrowers and the bank. These policies will, we believe, preserve principles important to bank regulation and supervison and to public confidence in financial institutions. We believe that the FDIC and the Federal Reserve are in substantial agreement with the concepts involved, and, as Chairman Seidman said, we have reached agreement on a series of proposals that we will submit to the committee after the hearing.

We are confident that the agricultural bank problems can be resolved through the cooperative efforts of banks, their supervisors, State governments, and the Congress. We are ready to work with you in achieving these needed changes.

[The complete prepared statement follows:]

STATEMENT OF

ROBERT L. CLARKE

COMPTROLLER OF THE CURRENCY

Before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

March 11, 1986

Mr. Chairman and members of the Committee, I welcome this opportunity to appear before you to discuss the problems being experienced by agricultural banks. As you are well aware, the American agricultural economy continues to experience severe difficulties. Farm incomes and asset values, particularly the price of farmland, continue to decline, weakening the financial condition of highly leveraged farmers and putting pressure on agricultural lenders. Agricultural banks must continue to adjust to the changing and uncertain conditions in agriculture. However, the problems faced by agricultural banks will ultimately be eliminated only when the agricultural problem itself is eliminated -- a process that may take several years, depending, among other things, on the future strength of export markets and the level of real interest rates.

This morning I would like to provide some background information on agricultural banks, and describe what actions our Office is considering to assist agricultural banks in making the

needed adjustments. Then I will discuss additional measures that could be taken by the Congress, the states, and the banks themselves to ensure that this adjustment is as smooth and painless as possible for both lenders and farm borrowers.

Profile of Agricultural Banks

Agricultural banks, defined as banks with over 25 percent of gross loans in agricultural credits, number 3,900 -- roughly a quarter of all commercial banks. These banks hold about half of the $50 billion in commercial bank credit to the farm sector, and their total assets constitute approximately 5 percent of the total $2.6 trillion in commercial bank assets. They are located mostly in the midwestern states, many of which have restrictive branching laws. As a result of this and because of the relatively small size of many of the communities they serve, the median agricultural bank is only one-half the size of the median nonagricultural bank. Seventy-three percent of the agricultural banks in this country operate out of a single office.

Until recently, agricultural banks generally out-performed comparably sized nonagricultural banks. Due to their heavy concentration in farm loans and the growing credit quality problems in that sector, however, the condition of many agricultural banks has deteriorated.

As of September 1985 (the most current data available on an aggregate basis), there were 861 national agricultural banks. One hundred sixty-two of these reported losses, compared with 116 at year-end 1984 and 60 at year-end 1983. The median ratio of classified assets to gross capital funds at all national agricultural banks reached 52 percent as of this same date, up from 39 percent one year ago and 30 percent two years ago. In contrast, the ratio for nonagricultural banks rose only slightly over the past two years from 19 percent in September 1983 to 24 percent in September 1985.

The deteriorating condition of many national agricultural banks is also shown by their increased presence among the ranks of problem and failed banks. As of year-end 1982, only one percent of national agricultural banks were problem banks (i.e., had CAMEL[1/] ratings of 4 or 5). However, as of December 1985, 12 percent of all national agricultural banks, or 102, were problem institutions. Of the 30 national banks that failed in 1985, 10 were agricultural banks.

Despite the significant problems facing many agricultural banks as the American agricultural economy adjusts to the changing world market, we believe that a significant majority

---

1/ The CAMEL rating is a summary of the condition, on a scale of 1 to 5, of a bank at the time of examination. It is based on assessments of capital, assets, management, earnings and liquidity.

have sound prospects for the future. Even with the large losses suffered by agricultural banks and the likelihood that these losses will continue to occur in the coming months, there remains substantial strength in agricultural banks. Many of these banks possess strong management that insisted on adhering to sound lending policies.

As a result, most agricultural banks hold significant amounts of capital and are continuing to generate earnings that equal or exceed that of other comparably sized commercial banks. As of September 1985, nine out of every ten national agricultural banks reported capital in excess of seven percent; two-thirds in excess of nine percent. While two out of every ten national agricultural banks reported year-end losses, almost two-thirds of all national agricultural banks reported a return on assets (ROA) of one percent or greater. In fact, while the average ROA of all agricultural banks has declined significantly over the past several years, it still remains higher than that of comparably sized nonagricultural national banks.

Our intention in providing these statistics is not to suggest that there is no problem. For the banks that fail, the consequences are traumatic -- for their employees, their shareholders, and the communities they serve. Moreover, the magnitude and severity of the problem has been made clear to us through our frequent meetings with national and state

agricultural bankers. These meetings have been held both in Washington, D.C. and in the home states of these bankers. As a result, we do recognize that among even the better-managed agricultural banks, many are under financial strain. No doubt, there will continue to be pressure on earnings and capital, given the agricultural outlook and the prospective downward trend in farm loan quality. However, we are optimistic that the bulk of the agricultural banking sector possesses the resources, management talent, and willingness to work with their borrowers going forward, and we believe that efforts should be directed toward finding ways to strengthen and assist them during this difficult period.

The OCC's Proposal

It is our view that the most beneficial thing we can do for those banks and their borrowers is to ensure that they have the opportunity and incentive to work with their borrowers to achieve mutually satisfactory loan workout plans. In particular, we must identify and remove obstacles that inhibit banks from successfully helping themselves and their borrowers. It is only by identifying their losses and restructuring credits to reduce farmers' debt burdens, that agricultural banks will be able to put their problems behind them and improve the quality of their loan portfolios.

Although such restructuring would be in the long-run best interest of banks and their borrowers, many banks have been reluctant to write down loans or grant other concessions to borrowers because of the effect this might have on their capital levels. In particular, banks fear that reduced capital levels could prompt regulators to direct them to make immediate increases in capital. In addition, they are reluctant to reduce capital because of the lower lending limit that would result.

The three federal bank regulatory agencies have been considering for some time a variety of ways that banks could be given the tools and the encouragement to effect long-term restructuring of problem credits. Among the options are the following, none of which require legislative action and all of which could be implemented by regulatory decisions.

First, banks could be encouraged to understand and use the provisions of Financial Accounting Standards Board Statement No. 15 (FASB 15) to account for restructured debt. FASB 15 can, under certain circumstances, be used to account for concessions in financing terms (i.e., reduction of either principal or interest) granted to borrowers experiencing financial difficulty without requiring the institution to record any losses. FASB 15 has not been readily used in the past. Many bankers simply have not been aware of its existence. Moreover, it is, at least on the surface, somewhat complex. Finally, it is of limited use in situations where an actual credit loss has been incurred.

Nevertheless, it is there to be used and we would propose calling it to the attention of bankers by reiterating the manner in which it can be used. It is a useful device. An example of how it would work follows.

FASB 15

Assume that a farmer has borrowed $100,000 at 12 percent for 5 years. Using a straight-line amortization schedule and simple interest, the farmer's payments would total $136,000 over the five-year term. Assume the borrower's cash flow drops so that he can no longer afford to pay the entire amount over the five-year term. To accommodate this reduction in cash flow, the lender can restructure the loan by extending the maturity, foregoing principal, reducing the interest rate, or some combination of the three. As long as the total cash payments to the lender aggregate to $100,000, the original amount of the loan, and the restructuring is done based upon reasonable propspects for repayment, under FASB 15, the lender would not have to write down the loan and recognize losses.

Second, we would propose modification of the present call report disclosure requirements for restructured loans to allow banks to distinguish those loans that, although restructured, are in compliance with the new terms. Under this proposal, such restructured loans would no longer be included in the category of nonperforming loans. Such a change would require a revision in the call report, which we are prepared to initiate immediately.

Third, and perhaps most importantly, we are considering the option of capital forbearance that we believe will encourage banks to write down problem loans and develop workout plans.

The essence of this option is to encourage agricultural banks to recognize losses, but allow them to operate temporarily with lower levels of capital. Because a primary purpose of capital is to absorb unanticipated losses, we believe that agricultural banks should now take advantage of their traditionally high levels of capital.

Capital forbearance, which is really a variation on loan loss deferral plans -- but a better one we think -- would permit banks to place a portion of their agricultural loan charge-offs into a segregated account. The amount in the segregated account could not exceed some percent of the bank's primary capital. Additions to the segregated account could be made during the first two years after implementation of the policy. The segregated account would then be amortized in equal increments during the five years immediately following the addition to the segregated account. Thus, the segregated account would exist for a maximum of seven years. An example of how this option could be utilized follows.

Capital Forbearance

Assume that an agricultural bank with $50 million in assets and $5 million in capital incurs loan losses of $1 million. Under our present rules, the loans would be charged off against the loan loss reserve which the bank is required to maintain. Because the reserve is permitted to be included in primary capital, the $1 million charge against the reserve would reduce the bank's capital by $1 million.

Under the capital forbearance option, the $1 million in agricultural loan losses would be placed in a segregated account and included as a memorandum account for reporting purposes. The segregated account would be reduced by $200,000 per year over the following five years.

We believe capital forbearance would be responsive to the needs of agricultural banks and their borrowers during a difficult period of transition for a number of reasons. First, it is our hope that it will encourage banks to take advantage of the Farmers Home Administration (FmHA) Debt Adjustment Program. Under this already existing program, FmHA guarantees up to 90 percent of a renegotiated loan on which the bank has made interest and/or principal concessions sufficient to enable the borrower to service the restructured debt. The OCC has supported this program, which has the potential of benefitting both the borrower and the lender, and has encouraged bankers, through an examining issuance, to take advantage of it.

However, participation in the Debt Adjustment Program has been limited, at least in part, because of the reluctance of banks to write down loans and suffer the immediate diminution of capital. Under the capital forbearance option, the write-down could qualify the loan for the FmHA guarantee program, but would not trigger a regulatory response for more capital. By augmenting a farm lender's ability to grant concessions and, thereby, improve the ability of troubled borrowers to service

their debts, the capital forbearance option would increase the likelihood that a satisfactory work-out could be arranged.

Another attractive feature is that capital forbearance will primarily benefit agricultural banks that have sufficient earnings to absorb the charge-offs and to replenish capital. In fact, banks that utilize this option will have increased motivation to undertake the adjustments necessary to bolster earnings. In effect, capital forbearance formally acknowledges that capital should be utilized during periods of unusually heavy loan losses, and that replenishment takes time. It would not, however, provide any support to those banks that have completely exhausted their capital, nor would it assist banks that have little or no prospect of returning to profitability. While these banks would continue to receive our supervisory efforts toward recovery, any special assistance might serve to simply prolong their difficulties without improving their prospects for recovery, thus raising the potential liability to the FDIC.

Capital forbearance would have other benefits as well. It would set simple limits to give agricultural banks a clear understanding of the regulatory concession. Agricultural banks could easily calculate their losses and resulting capital position. Moreover, write-downs taken to qualify loans for the

FmHA guarantee could reduce the amount of classified assets, thereby improving the quality of a bank's remaining loan portfolio. Also, by encouraging banks to make legitimate charge-offs, it could enable them to reduce their tax bill or recover previously paid taxes.

There are also administrative advantages to this option. It requires no statutory change. Although it initially specifies a seven-year time frame, we would have the flexibility to extend it if conditions so warrant. It is easily understandable and self-executing, which means that bankers can enjoy the benefits immediately rather than make an application to the regulator and wait for a response. Finally, it utilizes existing programs and would not represent significant increased resource costs to the banking agencies.

We view capital forbearance as superior to other transitional assistance devices that have been suggested because it would accomplish the same end but avoids several adverse consequences that are inherent in the other proposals. Loan loss deferrals are a case in point. Loan loss deferrals would permit a bank to write down the loss portion of a problem loan over an extended period of time rather than all at once. Because the deferred write-downs would temporarily qualify as capital, they, in effect, accomplish the same thing as capital

forbearance -- i.e., permitting a bank to operate with a weaker capital position than would normally be required by a regulator.

However, a loan loss deferral plan, unlike capital forbearance, would distort the financial statements. It would result in a misleading report of a bank's net income and shareholders' equity because write-downs would not be accurately reflected. In our view, this is a serious shortcoming. The advantage of the capital forbearance option that we are advancing is that losses are recognized when they occur and clear disclosure is made to the reader of the bank's financial statements as to the transitory nature of the segregated account -- yet banks still receive the needed time to bring their capital back to historical standards. Thus, the integrity of financial statements would be preserved so that neither shareholders nor the general public would be misled about a bank's financial condition.

The loan loss deferral plans that have been proposed may be flawed in another respect as well. They may encourage agricultural banks to postpone dealing with their problems by allowing an extended period of time for loan loss amortization. The capital forbearance option, on the other hand, would operate within a shorter time horizon to enable agricultural banks to confront their problems more immediately, resulting in earlier

identification of losses and restructuring of loans. The workout period for the farm borrower would, of course, be unlimited. Once the losses are taken and loans are restructured, banks can get on with the task of building back capital -- free from the albatross of an extended loss deferral that will penalize earnings for a long time in the future.

The proposed capital forbearance option is also superior to simply lowering capital requirements on a case-by-case basis, as has been suggested by some. A simple lowering of capital requirements would result in a parallel decline in the bank's maximum lending limit -- posing problems for both borrowers and lenders in renewing and restructuring loans. Amending the lending limit requirement to correct this problem would then require statutory revision. Under the capital forbearance option, the segregated account containing the agricultural loan losses could be counted toward capital for lending limit purposes. Also, unless capital requirements were lowered across-the-board, which would also require a lengthy regulatory change, banks being dealt with on a case-by-case basis would not know what kind of regulatory response to expect as they write down loans. The capital forbearance option has none of these disadvantages since it applies equally to all agricultural banks and requires no application process.

In sum, the capital forbearance option is intended to provide agricultural banks experiencing a drain on capital that is deemed to be temporary, a reasonable time within which to restore capital to adequate levels. With the benefit of temporary capital relief, bankers would have an incentive to recognize losses present in their loan portfolios, work with farm borrowers to restructure loans, and rebuild their capital in an orderly, planned manner.

Other Needed Measures

Although we believe that capital forbearance will help agricultural banks deal with their current problems, it is not a panacea. It does nothing to mitigate the underlying causes of problems faced by agricultural banks. Agricultural banks will need strong earnings to replenish their capital and to ensure their long-run survival beyond the current downturn in the agricultural economy. To make this possible, it is critical to make changes that address the fundamental problems of inadequate asset diversification opportunities and inability to generate non-interest income. Congress and state legislatures can facilitate these changes, although their ultimate success will depend upon efforts made by the banks themselves.

Actions Needed by Congress and State Governments

In our view, the most important thing agricultural banks can do to improve their ability to withstand future downturns in the farm sector is to diversify their assets. A high concentration of loans to, or dependent upon, a particular industry is generally an imprudent lending strategy because it makes banks extremely vulnerable to that industry's performance. Some of the concentrated portfolios in agricultural banks resulted from conscious decisions by bank owners and management, who were willing to gamble on high land prices going higher -- even when the economic returns produced by the land did not justify those decisions. However, the concentrated portfolios of agricultural banks are also attributable to factors beyond their control. Among those are restrictions on geographic expansion and on loan sales and purchases.

Principal among geographic constraints are state-law limitations on intra-state branching and prohibitions against interstate multibank holding companies. Those constraints often make it difficult for banks in agricultural areas to diversify their loan portfolios, both by location and by the business of their borrowers. Geographic restrictions also have particular impact in the case of failing or failed banks. More flexible laws are needed to encourage and facilitate acquisition of troubled and failed banks.

Finally, geographic restrictions prevent banking services from being provided in the most efficient manner possible. Where branch banking is prohibited or severely limited, banks can enjoy the economic benefits afforded by larger organizations only by joining a multibank holding company. A bank that is part of a multibank holding company must still be separately incorporated and must have a full complement of officers and directors.

In light of these problems, we encourage states with restrictive intra-state branching laws to consider changing these laws to open new opportunities for lending to agricultural banks and to facilitate the evolution of economically efficient banking structures. We also encourage Congress to consider amending the emergency acquisition provisions of the Garn-St Germain Act of 1982 by reducing the eligible asset size and allowing the acquisition of the entire holding company of a troubled bank rather than just the bank. Such liberalization would expand the alternatives for preventing and resolving bank failures. This would help ensure the continued availability of banking services to farm communities.

As important as the removal of restrictions on geographic expansion is, it alone will not be sufficient. One of the major causes of declining credit quality in the agricultural sector is

depressed farm real estate values. For that reason, states should be encouraged to remove prohibitions on farm ownership that limit the market for farmland. The OCC has responded to this problem by generally allowing national banks to hold farmland acquired through foreclosures for as long as ten years, the maximum allowed by law. As a result, these banks are not forced to put real estate on the market at an inopportune time, which could further depress farmland prices.

If agricultural banks are to continue to serve adequately their farm communities and avoid the problems in which they find themselves today, they need to increase the diversification of their borrower base. However, this may be difficult for a number of agricultural banks, particularly those in states where agriculture and related industries dominate the economy. The larger regional and multinational banks can originate loans nationwide and thereby lend to a variety of industries, but it is virtually impossible for smaller banks to achieve the same level of diversification. As a practical matter, a $20 million rural agricultural bank has no well-established market in which it can sell its loans or purchase interests in loans originated by other banks, nor are there shares of well-diversified loan pools available for purchase.

Although the acquisition of loan participations is one way for banks to diversify their loan portfolios, there are some

obstacles that particularly impact the smaller community banks. Glass-Steagall prohibitions against commercial bank underwriting of securities mean that loan participations must be carefully structured. They tend to be available only in relatively large denominations -- usually $1 million or larger. Also, they can have only a limited number of potential acquirers. Finally, acquiring banks are required to receive and analyze extensive documentation associated with each participation. Collectively, these features of loan participations limit their usefulness for smaller banks.

If smaller banks are to become active participants in the market for loan sales and purchases, such loans will have to be converted into securities that can be freely transferred among investors. Those securities would have to be available in relatively small denominations and in a form like bearer bonds, that are freely transferable among depository institutions. Optimally, a secondary market with quoted prices would exist. Only the mortgage-backed securities market now has these characteristics.

Before such a market can develop for either shares of whole loans or loan pools, however, federal law must be changed to permit national banks to underwrite the sale of interests in pools of loans and to participate in private placements.

Specific authorization by Congress for commercial bank underwriting of interests in pools of bank loans, either by private placement or public offering, could significantly enhance the availability of loan sales and purchases for small banks.

Not all of the impediments to banks forming and selling security interests in loan pools are the result of legal constraints. One issue that can be addressed through regulatory action involves structuring the securities so that the purchasing bank has certain protections against default by the underlying borrowers (e.g., allowing the pooling bank to replace loans that become problem loans with performing loans), while granting the pooling bank the right, nonetheless, to remove the pooled loans from its books for reporting purposes. In conjunction with banks that have presented loan pooling proposals, our Office is developing procedures to deal with this and a number of other issues. We will continue to work with the banks and the other regulatory agencies in order to facilitate opportunities for asset diversification. We will also continue to develop policies that assure these growing methods of asset diversification are pursued in a safe and sound manner.

Actions Needed by Agricultural Banks

While actions by the Congress, the states, and bank supervisors would certainly ease the transition agricultural banks need to undergo, their long-term survival requires that agricultural banks themselves take several actions.

First, as we have outlined in guidelines issued to national banks, they should review the effectiveness of their lending policies. Unfortunately, a number of banks still lack adequate agricultural lending policies. In such cases, we stress that they should be established or revised to include:

- analyzing each borrower's cash flow and profitability from production before the loan is made;
- establishing and maintaining accurate and realistic appraisals on all collateral supporting agricultural loans;
- identifying repayment sources and establishing specific repayment terms for various categories of agricultural loans; and
- building a cushion in collateral values and anticipated cash flows to protect against a downturn in such values or cash flows.

Agricultural banks that ensure that accurate risk assessment and prudent collection policies and practices are in place will be less vulnerable to deteriorating loan quality, even during economic downturns.

In addition, agricultural banks should make an effort to reduce their reliance on the agricultural sector. They must, of course, serve the credit demands of their marketplace. However, banks should continue to work with their local communities in attracting new industries, and take advantage of opportunities for asset diversification as they become available.

As I indicated in my testimony last week before this Committee, the failure to modernize banking statutes has prevented many banks from reducing their reliance on lending. Product limitations have also made it difficult for banks to seek alternative sources of income as their traditional activities have become less profitable. While such expanded activities have often been viewed as helping primarily large institutions, there is a tremendous opportunity for small banks to act as brokers in offering financial products such as mutual funds, or to enter into joint ventures with other banks for the delivery of these products. New opportunities for diversification of assets and income sources will make banks less susceptible to any future problems in the agricultural industry.

Conclusion

The current difficulties experienced by agricultural banks reflect farmers' severe financial stress. It is unrealistic to expect that the agricultural sector will return to the prosperity enjoyed during the 1970s anytime in the foreseeable future. Consequently, the agricultural economy, including banks operating in that economy, will have to adjust to a lower level of farm income and reduced asset values more in line with prospective income.

We believe the regulatory policies inherent in our proposals today will provide agricultural banks with incentives and the time needed to address asset quality problems in a thoughtful and orderly manner, meeting the needs of the borrowers they serve and helping to rehabilitate both the borrowers and the bank. These policies will, we believe, preserve principles important to bank regulation and supervision and to public confidence in banking institutions. We believe that the FDIC and Federal Reserve are in substantial agreement with the concepts involved.

We are confident that agricultural bank problems can be resolved through the cooperative efforts of banks, their supervisors, state governments and Congress. We are ready to work with you in achieving these needed changes.

The CHAIRMAN. Thank you very much.

Governor Martin, we understand at the conclusion of your testimony that you have to leave, but Mr. Taylor will stay and answer your questions.

Please proceed.

STATEMENT OF PRESTON MARTIN, VICE CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM, ACCOMPANIED BY WILLIAM TAYLOR, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION

Mr. MARTIN. Thank you, Mr. Chairman. I appreciate the courtesy. I would ask that the text of my full statement be entered into the record at the conclusion, Mr. Chairman.

The CHAIRMAN. Yes; it will be.

Mr. MARTIN. I will be brief, in that the representatives of the other two Federal banking agencies have described a set of policies and approaches that are roughly consonant with the thinking of our Board.

I am pleased to appear before this committee to review the very difficult situation experienced by banks in our agricultural communities and to discuss the proposals that have been reviewed here at prior hearings and in the previous testimony today.

Our Board has the advantage of the counsel and advice of a number of committees in each of the Federal Reserve districts. They are made up of representatives of agriculture and of small business. I might say that in my attendance at certain of those meetings in recent months, I'm hearing less and less from small business and more and more from the farmers who are on those advisory committees.

DESPERATE FARM SITUATION

Certainly, the problem of almost a depression in certain parts of the agricultural sector are more serious than any encountered in decades, since the Great Depression years. The committee knows full well that farm incomes and farm asset values have declined so sharply in this current decade in world markets and in our own markets, as prices have responded to what some have styled an overcapacity in world supplies of farm products relative to demand.

All of our farmers have been adversely affected by these developments, but as previous testimony has outlined, certainly, there is a wide distribution, and the degree to which farmers have been adversely affected varies significantly. Farmers that are relatively debt-free generally continue to have strong financial positions, but even their financial positions—their net worths on a market-to-market basis—are significantly less than a few years back.

The problems of our farmers, of course, have been compounded by the relatively high interest rates that have prevailed over the current decade; and efforts by farmers to restructure their debt or to reduce it by selling assets have been constrained greatly by the decline in farm asset values, which in some cases continues.

Testimony has already been given that about one-quarter of the total farm debt is provided by commercial banks and that the

banks that have concentrations of such loans have been experiencing increasing strains in recent years.

The data with regard to failure and slow paying, and so forth, have also already been given.

It is interesting, even shocking, that agricultural banks, as we define them, have charged off more than 2 percent of their total loans during 1985, a chargeoff rate that is perhaps four or five times the normal loan chargeoff rate. These loan losses and the need to add to loan loss reserves because of the increasing volume of poorly performing and even nonperforming loans have, of course, reduced the earnings of many farm banks, which means that their additions to capital have been likewise constrained.

In too many cases, earnings have turned to operating losses, and capital has been eroded, sometimes substantially so. A 1 to 2 percentage point erosion of capital off of a 9-percent capital ratio is widespread. The result has been that an increasing number of farm banks have failed and the number of seriously troubled banks has risen substantially.

To put this in perspective, our data show that over 95 percent of the total loans of all agricultural banks are performing, and, indeed, one-half of these banks reported earnings equaling or exceeding 10 percent of equity. The capital asset ratio of all agricultural banks averaged 9¾ percent last year, higher than it was at the start of the decade and well above the 7½-percent ratio for the entire banking system. But again, the caveat is that these ratios are being eroded in hundreds of cases.

What are the prospective supply conditions for farm products, both at home and internationally? You have reviewed these projections repeatedly here. Suffice it to say that a substantial rebound in crop prices and thus in farm incomes does not appear likely to take place in the near term. Certainly, it would appear unwise to base public policy on the assumption that such a rebound would take place soon.

Farmers who are now financially healthy and are not highly leveraged should be able to avoid serious problems, and many borderline farm operators may be able to work out of their current difficulties. Of course, there are the other farmers with a relatively heavy debt load who are facing a continuation of serious difficulties.

In turn, that means that a sizable number of farm banks will also continue to experience severe strain.

The Board, at your request, has reviewed proposals under consideration by Congress to assist troubled farm banks, to aid them and their farm customers through this terrible transition.

Let me summarize and review certain of these policies that our Board will employ to provide assistance to basically sound, well-managed farm banks.

Dept restructuring has been reviewed here already. This is an approach that can be taken to deal with the present debt problems of farm banks and their farm customers. We agree with the other regulators that voluntary restructurings should be treated according to generally accepted accounting principles.

We also share with the other regulators who have testified here the positive view of FASB–15. Given the seriousness of the existing

problems in the agricultural sector, the Federal Reserve believes that regulatory policies followed by examiners in classifying loans should give full consideration to FASB–15 and to other GAAP accounting procedures. My colleague who is here will be, as the chairman has indicated, ready to answer questions. He has engaged in a series of training sessions for orientation and development of materials for our examiners.

PROPOSALS FOR RESTRUCTURING DEBT

There are, of course, a number of proposals for restructuring the terms of farm debt that would involve the Government in a decidedly more active way. Some have proposed and some States have acted to impose a moratorium on agricultural loan foreclosures. And as we know, in the moratorium period, the farmers retain title and use of the land, while getting relief from the drain of interest and principal payments placed on their cash-flow. Such help, of course, comes at the expense of the farm lenders, however, and this can prove particularly detrimental to the financial health of already weakened agricultural banks. The imposition of such arrangements, moreover, casts a long shadow over future credit extensions. This is a long, long workout period.

Other proposals for Government-assisted debt restructuring arrangements would induce voluntary participation by both borrowers and lenders on an incentive basis through Government subsidies, or Government guarantees. These arrangements with the Farmers Home Administration, for example, genuinely assist both farmers and farm banks; and in some cases, of course, the costs are up front for all to see.

With regard to net worth certificates, and loan loss writeoff deferrals, we've had, of course, experience with thrift institutions. A stretch out of agricultural loan loss writeoffs or issuance of the net worth certificates would boost regulatory capital without injecting real capital.

The basic objective, of course, is to buy time for a bank to restore its real capital—whether out of earnings or otherwise—and to accomplish this end with the net worth certificate approach, an exchange of promissory notes between the troubled bank and the FDIC or possibly a primary regulator. The loan loss deferral approach permits a writeoff of those losses over an extended period of time and has already been commented on here. And the deferral would be available to all banks meeting specified qualifications. Net worth, in theory at least, can be targeted. In practice, as we know from the thrift industry, this has proved a bit difficult.

Our Board has expressed strong reservations about the use of either net worth certificates or loan loss stretchouts. In particular, these techniques raise the question of whether regulatory accounting practices should differ from generally accepted accounting principles. Again, a long-term workout needs to get capital into agriculture, needs to get capital into the farm banks.

Under these two proposals, regulatory accounting statements would show levels of capital that substantially exceed those reported on financial statements under GAAP. And that complicates the long-term workout, the attraction of capital.

59-527 O - 86 - 5

In addition, such techniques do not address a bank's fundamental financial situation. They buy time, but they do not in themselves provide a direct means for solving the problems.

Consequently, in our view, these approaches are likely to be largely ineffective for most seriously troubled institutions whose real capital has been seriously eroded, depleted by loan losses, and whose earnings prospects are poor.

In these cases, our Board believes it would be far better to seek a permanent solution to the bank's problems by having it obtain new capital, or, if its problems are too severe, by merging it with a stronger institution.

There are of course less extreme situations in which a bank has suffered setbacks but still retains a sizable amount of capital, although less than normally maintained or even less than regulatory standards for capital. Many of these banks have reasonably good prospects for recovery over time. They need time.

In these situations, a more straightforward way of buying time would be simply for the supervisors to permit them to operate for some interval with capital at levels below supervisory standards. The Federal Reserve has already followed this capital forbearance approach in applying its capital guidelines. We recognize that an important function of capital, after all, is to absorb unexpected losses and that you don't keep all of the fire engines in the firehouse.

One problem that does arise when a bank's capital is temporarily depleted is that its single borrower loan limit is reduced commensurately, as has already been testified here, because this limit is based on percentage of capital.

So, although the loan may have been within the single borrower limit at an inception, a reduction of capital from loan losses can, and many times does, preclude the restructuring of these loans.

This occurs even though the absolute amount of the loan could be, and in many cases is, constant. It's our view that this problem could be dealt with if the agencies would agree to utilize the provisions of existing, generally accepted accounting standards as set out in FASB–15. If we use that standard, it would not be necessary, or advantageous, to issue net worth certificates or endorse the deferral of loan losses.

To sum up, it has been clear for some time, some extended time, that a substantial number of farm families and farm banks are experiencing extreme difficulty. In the light of this situation, the Board believes that Congress and the banking agencies should take action that will provide assistance to the agricultural sector, while, at the same time, not undercutting effective and appropriate supervision of and accounting for the activities of farm banks. In particular, the Congress and State legislators can make a much needed contribution by helping to maintain the provision of banking services to small communities—many of them one-bank communities.

EASING INTERSTATE BANKING LAWS

The Garn-St Germain Act of 1982 presently prohibits acquisitions of troubled banks across State lines before they have failed

and acquisitions of failed banks with assets under $500 million. We believe these two constraints should be eased by allowing failing bank acquisitions across the State lines, and by reducing the size criteria so as to maintain the banking services in these farm communities. An easing of State restrictions on branching could also help maintain banking services in small towns in cases where a separately organized and capitalized bank might not be viable.

There are also important things that should be done by the banking regulators in these difficult times. So let me, on behalf of our Board, join the two preceding executives of Government agencies in the following:

First, we propose and join in the reaffirmation of the policy of not discouraging banks from exercising forbearance on farm loans; we shouldn't get in their way. That's the banker's decision—forbearance on loans that are being restructured when there is a reasonable prospect that this will work to the mutual benefit of bank and farmer-borrower.

Second, we endorse the forbearance that the agencies should bring forth in applying the principles of FASB-15. That is, the agencies should not require that a loss be recognized on a farm loan unless the anticipated cash receipts of the restructured debt are not sufficient to cover the principal amount of the loan.

Third, we believe the agency should modify regulatory reporting requirements so that loans appropriately restructured no longer need to be classified as nonperforming loans.

Fourth, the single borrower limit should be changed or interpreted to prevent restructured loans from being held in violation of the limit based solely on a temporary decline in the bank's capital.

Fifth, we believe the agencies should offer a clear statement of their intention to employ a simple policy of capital forbearance.

Mr. Chairman, I thank you for your courtesy in permitting this truncated statement.

[The complete prepared statement follows:]

For release on delivery
March 11, 1986

Statement by

Preston Martin

Vice Chairman, Board of Governors

of the Federal Reserve System

before the

Senate Committee on Banking, Housing and Urban Affairs

March 11, 1986

I am pleased to appear before this Committee today to review the problems being experienced by banks in our agricultural communities and to discuss various proposals that have been advanced to ease the strains resulting from these problems. As you know Mr. Chairman, Chairman Volcker recently sent you a letter that presented the Federal Reserve Board's views on these matters and in conjunction with that letter a rather extensive study by our staff of farm credit conditions and their impact on farm banks was forwarded to the staff of your Committee. Accordingly, I intend to structure my remarks this morning to highlight the main points made in those documents.

The problems currently afflicting the agricultural sector of our economy are more serious than any encountered since the Great Depression of the 1930's. Farm incomes and farm asset values have declined sharply over the current decade as crop prices -- responding to a major increase in world supplies of farm products relative to demand -- have dropped substantially from boom-time levels of the late 1970's. All of our farmers have been adversely affected by these developments but not to the same degree. Farmers that are relatively debt-free generally continue to have strong financial positions although significantly less so than a few years back. In contrast, farmers who entered the 1980's substantially in debt have experienced an erosion in their financial health that generally is the more serious the greater the degree of their leveraging.

Our staff estimates suggest that perhaps a third of the full-time producers on commercial-sized family farms are experiencing moderate to severe financial stress. This group owes about one-half of the farm debt

of all such operators. The problems of these farmers, of course, have been compounded by the relatively high interest rates that have prevailed over the current decade. In addition, their efforts to restructure debt, or to reduce it by selling some of their assets, have been hampered greatly by the decline in farm asset values.

The great proportion of farm debt is owed to the Farm Credit System, the Farmers Home Administration and individuals. But about one-quarter of the total is provided by commercial banks, and the banks that have concentrations of such loans have been experiencing increasing strains in recent years. For example, loans delinquent 30 days or more at agricultural banks amounted to 7 1/4 percent of total loans at the end of last year, up from 6 1/4 percent a year earlier. This increase took place even as these banks charged off more than 2 percent of their total loans over 1985. These loan losses and the need to add to loan loss reserves because of the increasing volume of poor performing and nonperforming loans have substantially reduced the earnings of many farm banks. Indeed, in all too many cases earnings have turned negative and capital has been eroded, sometimes substantially so. The result has been that an increasing number of farm banks have failed (68 last year) and the number of seriously troubled banks has risen substantially.

It is important to keep the present situation in proper perspective, however. Over 95 percent of the total loans at all agricultural banks are performing, and one-half of these banks reported earnings equal to at least 10 percent of their equity. Also agricultural banks generally have a substantial capital cushion to absorb loan losses. The capital asset ratio

for all agricultural banks averaged 9 3/4 percent in September of last year, higher than it was at the start of the decade and well above the 7 1/2 percent ratio for the entire banking system.

There are a number of recent developments that should work to assist the farm economy, including the recent dramatic fall in energy prices and the substantial declines in interest rates and in the exchange value of the dollar that have occurred over the past year or so. The recently enacted farm bill also offers an additional source of support for farm incomes. At the same time, however, prospective supply conditions for farm products both at home and internationally, suggest that a substantial rebound in crop prices, and thus in farm incomes, is not likely to take place over the foreseeable future. Certainly it would appear unwise to base public policy on the assumption such a rebound will take place. Accordingly, while farmers that are now financially healthy should be able to avoid serious problems and many borderline farm operators may be able to work out of their current difficulties, many other farmers with relatively heavy debt loads face a continuation of serious difficulties. That means, of course, that a sizable number of farm banks will also continue to experience severe strains.

Mr. Chairman, it is altogether understandable, that the Congress is seeking to identify approaches by which appropriate assistance can be provided to troubled farm banks to aid them and their farmer customers to get through this period. As I indicated at the beginning of my remarks, the Board, at the request of the Congress, has reviewed a number of proposals that are under consideration by Congress to accomplish this goal. In my remaining time I will summarize the Board's assessment of these proposals

and review certain supervisory policies the Board intends to employ to provide assistance to basically sound, well-managed farm banks.

Debt Restructuring

One approach that can be taken to deal with the present debt problems of farm banks and their farmer customers is to restructure that debt. Traditionally, when borrowers have been unable to meet their debt service obligations but appeared to have a reasonably good prospect of eventually repaying a loan, lenders have been willing to practice forbearance by changing the terms of loan agreements to make them more compatible with the altered economic circumstances of the borrower. In addition, in some cases, lenders have extended additional credit to troubled borrowers when it appeared that that might significantly improve their prospects of ultimately returning to economic health and repaying all their indebtedness.

In considering voluntarily arranged loan restructurings, the treatment of such restructurings by Generally Accepted Accounting Principles deserves special emphasis. In particular, Financial Accounting Standards No. 15 specifies that in cases in which the total of cash receipts that can reasonably be expected to be received under the terms of a restructured loan are at least equal to the original principal value of the loan, a lender need not change the value of the loan shown on its books.

Given the seriousness of the exiting problems in the agricultural sector, the Federal Reserve believes that regulatory policies followed by examiners in classifying loans should give full consideration to GAAP accounting procedures.

In addition to debt restructurings that are undertaken voluntarily by both lender and borrower without governmental assistance, there are, of course, a number of proposals for restructuring the terms of farm debt that would involve the government in a decidedly more active way. Some have proposed that a moratorium be imposed on loan foreclosures (by either the Federal or state governments). This amounts to a kind of forced restructuring of debt because over the moratorium period farmers would retain title to and use of their land while being relieved of the drain that interest and principal payments place on cash flow. Such a restructuring would clearly assist farm borrowers, at least in the short-run. But such help would come at the expense of farm lenders and could prove particularly detrimental to the financial health of already weakened farm lenders. The imposition of such arrangements, moreover, would cast a long shadow over future credit extensions.

Other proposals for government assisted debt restructuring arrangements would induce voluntary participation by both borrowers and lenders through the provision of government subsidies or guarantees. Such governmental arrangements -- as for example those offered by the Farmers Home Administration -- have the quality of generally assisting both farmers and farm banks. At the same time, such assistance does not come free; its provision would add to government costs either immediately or in the future and thus present yet another obstacle to achieving a much required reduction of the Federal deficit.

Net Worth Certificates and Loan Loss Write-Off Deferrals

Other proposals under consideration by the Congress -- the stretch-out of loan loss write-offs and issuance of net worth certificates -- would not result in an immediate expenditure of public funds, although both likely would add to the FDIC's costs over the longer run. Both these devices would boost regulatory capital without injecting real capital, the basic objective being to buy time to enable a bank to restore its real capital. This end would be accomplished with the net worth certificate approach through an exchange of promissory notes between the troubled bank and the FDIC (or possibly its primary regulator) and with the loan loss deferral approach by permitting a write-off of loan losses over an extended period of time.

One important difference between the two approaches, as they have generally been proposed, is that loan loss stretch outs would be available to all banks meeting specified qualifications while net worth certificates could be issued to selected institutions on a more discretionary basis. While in theory a loan loss deferral program could be structured to provide more targeted assistance, in practice this might be difficult.

In its letter to this Committee, the Board expressed strong reservations about the use of either net worth certificates or loan loss stretchouts. In particular, the Board noted that they raise the question of whether regulatory accounting practices should differ significantly from Generally Accepted Accounting Principles. Since under these proposals regulatory accounting statements would show levels of capital that substantially exceeded that

reported on financial statements prepared under GAAP, this would tend to cause public confusion and impair the usefulness and credibility of regulatory financial statements.

In addition, the Board noted that such techniques do not address a bank's fundamental financial situation. While they buy time for a bank to improve its condition, they do not in themselves provide a direct means for achieving that end. Consequently, in the Board's view, these approaches are likely to be largely ineffective for most seriously troubled institutions whose real capital has been wiped out or greatly depleted by loan losses and whose earnings prospects are poor. In these cases the Board believes it would be far better to seek a permanent solution to the bank's problem by having it obtain new capital or, if its problems are too severe, by merging it with a stronger institution.

There are, of course, less extreme situations in which a bank has suffered set-backs but retains a sizable amount of capital -- although considerably less than normally maintained or perhaps even less than required to meet minimum regulatory standards -- and has reasonably good prospects for recovery over time. In these situations, however, a more straight-forward way of buying time for institutions would be simply for supervisors to permit them to operate for some interval with capital at levels below supervisory standards. The Federal Reserve already follows this capital forbearance approach in applying its capital guidelines. We recognize that an important function of capital is to absorb unexpected losses, and that a bank that has recently utilized its capital for this purpose may not be in a position to replenish its capital resources immediately, although its long-run prospects may be quite favorable.

The CHAIRMAN. Thank you very much, Governor Martin. We'll excuse you as a witness at this time.

Mr. Clarke, you outlined three regulatory assistance measures, one, to use the FASB that we have talked about to encourage debt restructuring.

Two, modification of the present call report and disclosure requirements for restructured loans.

Finally, the option of capital forbearance.

Do you intend to assist those banks which have a large concentration of energy-related loans by use of any of those suggestions? Or, are you confining these recommendations only to agricultural problems?

CONCEPTS CAN BE APPLIED TO ANY FINANCIAL INSTITUTION

Mr. CLARKE. Mr. Chairman, we have confined our presentation and recommendations this morning to agricultural banks, banks that have high concentrations of agricultural loans, since that was the subject of the hearing. Certainly, the concepts can be applied to any financial institution with respect to any type of loan.

The CHAIRMAN. The reason I asked that question, in December, when we were trying to keep agricultural banks separate from the Farmers Home Administration new bill and all of that, energy prices were dramatically down. I don't know that I see any great difference in the end result of the problem, whether it's farm prices that are down, land values up, or whether it's expensive drilling equipment that's sitting around, and energy prices that are dramatically down.

I'm not necessarily advocating anything, I'm just asking the question: Is it fair to single out one group and not consider others who have difficulties as well?

Mr. CLARKE. As I say, I think that the concepts are equally applicable to any type of loan. The point of the exercise, of course, is to allow banks an opportunity to help themselves solve the problem over a reasonable period of time. Certainly, the same principle could be applied to energy banks or any other type of institution.

The CHAIRMAN. You say that, at least at the outset, FASB–15 is complicated and a lot of bankers may not understand how it works, or even that it's available.

How do you intend to educate bankers on FASB–15?

Mr. CLARKE. Obviously, the simplest thing to do for starters is to put out a release that calls it to their attention again. We put out a release in the past that discusses the availability of these accounting principles and given some examples.

If necessary, we can make that issuance easier to understand.

We can also provide direct assistance to bankers in connection with examinations and when they come into the office from time to time on how these accounting principles could be employed.

The CHAIRMAN. You make a very strong argument for the option of forbearance. However, I think you are well aware that there is a growing sentiment, not only on the committee, but in the full Senate as well to allow amortization of agricultural loan losses over a multiyear period.

Assume that the committee does choose a Loan Loss Deferral Program. How do you recommend that it could best be structured to be efficient? And also, how many years would you suggest that the loan losses be stretched out over?

FAVOR SHORTER PERIOD OF TIME

Mr. CLARKE. Obviously, we believe as a matter of regulatory policy that it would be better to have a shorter rather than a longer period because there is a tendency if you allow these things over a long period of time for banks to become overly dependent upon them. And changing economic conditions may make loss deferral inappropriate.

That's the reason we believe that the capital forbearance approach is better. Not only does it result in immediate recognition of losses, but it permits a much more accurate financial statement.

The CHAIRMAN. Mr. Seidman, you have also encouraged FASB-15 to be used. You indicated that you have instructed FDIC examiners to accept flexibility with respect to loan recognition, restructured loans, or losses directed by the Commission.

When will the use of FASB-15 take effect?

You have all testified in favor of it. It requires no legislation. When is it going to take effect?

Mr. SEIDMAN. In our case, Mr. Chairman, we have instructed our examiners to accept that treatment from banks that want to use it as of now, so that it is in effect as far as our banks are concerned.

The CHAIRMAN. Let me ask you the same question I asked Mr. Clarke then. Are you going to instruct your examiners to take the same position on energy-related loans where banks are in trouble?

Mr. SEIDMAN. I think, as far as generally accepted accounting, that ought to apply to all of those industries. Therefore, I don't restrict that. And we have not restricted our examiners to any one industry as long as it's accepted accounting.

We also hope that the general designation of these loans in a separate category would be applied wherever generally accepted accounting was used. The area that would be applicable to a particular industry or a particular sector would be the forbearance area. That would depend on the conditions in that area and whether they appeared sufficiently severe to have special capital requirements.

The CHAIRMAN. You indicate you are looking at the way the FDIC requires renegotiated debt to be reported.

You suggested that renegotiated debt could be renamed, "renegotiated, and performing according to new terms," and not included as part of the total, nonperforming loans.

What progress is the FDIC making in this area?

Mr. SEIDMAN. That has to be done uniformly among all regulators. In the call report, we have been working with the other regulators on that. They have accepted the concept. So now it's a matter of going through the procedures, including getting OMB's approval.

The CHAIRMAN. Mr. Taylor, Governor Martin addressed in his testimony the problems currently afflicting the agricultural sector

of our economy are the most serious encountered since the Great Depression of the 1930's.

The FDIC indicates that up to 300 agricultural banks may fail over the next 2 years. In light of the severity of the problem, would you agree that some type of temporary legislative assistance to help farm banks and borrowers through this transition period is necessary?

Mr. TAYLOR. Mr. Chairman, I think that to the degree that we successfully and forcefully implement the programs that have been outlined here this morning, it is hopeful that the legislation would not be necessary.

With respect to the question of FASB-15 and the issue regarding capital forbearance, I think it's encumbent upon us to put this to our field staff to assure that it is indeed implemented.

Hopefully, this will carry the day.

ENERGY PROBLEM BANKS INCLUDED UNDER FASB-15

The CHAIRMAN. Again, will you extend this policy to energy problem banks?

Mr. TAYLOR. Yes. I think the concepts of both FASB-15, and even more fundamentally, I think the concept of using the capital that one puts away for a rainy day, is something that we should utilize wherever it's necessary.

The CHAIRMAN. All of you have worked together to come up with a consensus, but in the FDIC's report it said if Congress decides to proceed with the relief program, it is the FDIC's view that the best option is a Loan Loss Deferral Program.

I recognize you are all saying you think you can handle it internally; it isn't necessary—but assuming Congress will act in some manner to aid agricultural banks, would you agree with the FDIC's statement that loan loss deferral is the best way to go?

Mr. Taylor.

Mr. TAYLOR. Mr. Chairman, I would submit not. I would submit that the capital forbearance plan, and especially the benefits of FASB-15, go a little bit further in locking in the benefits of renegotiation to the farm itself as opposed just to the banker.

It seems that both are in need of some kind of consideration. Anything that can automatically bring up the other to improve the benefits to both seems best.

The CHAIRMAN. Let me ask any one of you, or all three of you, if this can all be handled on a regulatory basis. This problem is not new. It has been going on for some months.

Why did it take the threat of legislation in these hearings for us to hear that you can do it with FASB-15? Why hasn't it just been done?

Any volunteers? [Laughter.]

Mr. TAYLOR. Mr. Chairman, I would volunteer that we are unfortunately in the business of trying to make wise selections among poor choices and that the catalyst of the Congress is probably helpful in this regard.

The CHAIRMAN. That was nicely put. [Laughter.]

Mr. Clarke.

Mr. CLARKE. Maybe the smart thing for me to do would be just to concur with that statement. [Laughter.]

The CHAIRMAN. Mr. Seidman, do you have any other observations?

Mr. SEIDMAN. Only that at least two of us are new on the job, Mr. Chairman, and we are just taking a real look at it, and we learn that as a result of focusing our attention on it we have come up with these suggestions.

The CHAIRMAN. It is nice to know that occasionally we have some impact.

Senator Proxmire.

Senator PROXMIRE. I would like to follow up on what the chairman was talking about.

The banking witnesses who testified last week said that if there is to be a program for aiding agricultural banks it needs to be implemented now in time for spring planting loans.

All of you have cautioned against legislation and have recommended a variety of regulatory measures which you have the power to implement without legislation, and yet as of today none of these measures that you talk about seem to have been implemented as a formal program.

So let me ask you, starting with Mr. Taylor, what is your timetable for putting these measures into practical effect?

You say the Congress acts as a catalyst.

Or let me put the question another way: If you have not acted to make your proposals effective within 15 days, why wouldn't it be fair and reasonable for this committee to conclude that you are not really serious and proceed to report the Dixon bill?

Mr. TAYLOR. Senator, I would hope that we would not fall into the description of not being serious about this. I think we are. I think that we should go forward to institute this immediately.

At the same time, I don't see anything in the program that we have proposed that couldn't fit in legislation if it were felt necessary. We could begin to plan to institute this program immediately.

READY TO IMPLEMENT IMMEDIATELY

Senator PROXMIRE. Immediately, what is that? Today?

Mr. TAYLOR. That would be today.

Senator PROXMIRE. Mr. Clarke.

Mr. CLARKE. Senator, I think it is important to note that the accounting principles set out in what is referred to as FASB–15 are already in place. We have an issuance out on the subject. I think our task now needs to be to encourage bankers to make use of those accounting principles. We need to emphasize the importance of bankers' using them.

Second, with respect to the capital forbearance proposal, it is one that applies across the board to a large number of banks and does not require individual applications to the regulators. This is somewhat of a departure from procedures used in the past. It is not something that you want to jump into without thinking through all of the ultimate ramifications.

Senator PROXMIRE. How long do you have to think about it?

Mr. CLARKE. We have been thinking about it for some time, and we are ready now to implement it.

Senator PROXMIRE. Again, what does that mean?

Mr. CLARKE. It could be implemented this afternoon.

Senator PROXMIRE. Will you do it?

Mr. CLARKE. Sure. We are ready to go. That is why the three of us are up here, in agreement that these proposals can be put into place.

Senator PROXMIRE. And you can put it into effect today.

Mr. Seidman.

Mr. SEIDMAN. I believe the same thing would apply to us. We have in fact—I visited several of the farm States and talked with our people about how they were handling banks in trouble, and we have attempted to put into place some forbearance already in terms of our guidance to banks when their capital falls below certain levels.

We have also looked at other forms of assistance in cases where it is appropriate.

So I believe that we are in fact doing this, although we can certainly move the program along more swiftly.

Senator PROXMIRE. Mr. Seidman, you raise an interesting point on page 3 of your testimony when you ask rhetorically—and I am quoting—you ask this question:

> How does one justify giving special treatment to banks that have financial difficulties due to agricultural problems when other financial institutions are suffering from problems due to weakness in other areas?

I would like to turn the question around a bit and ask you to explain to a lot of our constituent farmers how can we keep on rescheduling loans to Mexico and to lesser developed countries and not reschedule loans to our farmers.

Mr. SEIDMAN. I don't think we can. I think the same rules ought to apply to both, and I think FASB-15 that we have been talking about does apply to both and can be used by large and small.

The large banks have used it much more than the small banks.

Senator PROXMIRE. So the same rescheduling of loans to Mexico ought to be allowed for our farmers, right?

Mr. SEIDMAN. I think so, yes, sir.

Senator PROXMIRE. Let me ask you, Mr. Clarke. All of you have mentioned the possibility of banks using FASB-15. As I understand it, FASB-15 would permit banks to write down the principal on an outstanding loan without reporting a loss as long as the scheduled repayments of the principal and interest on the restructured debt are not less than the original principal and there is reasonable prospect of repayment.

To what extent do the regulations of your agency specifically permit the banks you regulate to be able to use FASB-15?

Mr. CLARKE. We have always encouraged the banks that we supervise to follow generally accepted accounting principles, and, as I mentioned earlier, we have a specific issuance that has been sent to all the banks specifically calling their attention to FASB-15 and giving examples of how they might use it.

While I have the floor, just for a second——

Senator PROXMIRE. Let me just follow up on that, and then you can take it.

Why have the bank regulators been so silent about FASB-15 up to now? It sounds like something you pulled out of a hat just for the purposes of this hearing.

Mr. CLARKE. No, sir. We have not intentionally been silent about this. We have an issuance out there that has been sent to every chief executive officer of a national bank and that explains at some length how FASB-15 can be used. In addition, a number of those banks made use of certified accountants to help them with their financial statements.

Senator PROXMIRE. How about the Fed banks, Mr. Taylor?

Mr. TAYLOR. Senator, we use generally accepted accounting principles where we think that they make sense, and in most cases they make sense.

In looking through what would be helpful that was existing today, we did find FASB-15, and we have no instructions out as to adherence to FASB-15 or nonadherence to FASB-15.

But we think this provides an avenue that today makes sense and we should exploit the benefits that are potential in it, and that is what we are trying to do.

Senator PROXMIRE. Mr. Seidman, how about the FDIC?

Mr. SEIDMAN. The FDIC also has notified people of FASB-15. However, when the 90-10 program was put in, the agricultural program about 2 years ago, we instructed our people not to use FASB-15. We have now reversed that.

Senator PROXMIRE. You reversed that as of when?

Mr. SEIDMAN. As of 2 or 3 days ago.

Senator PROXMIRE. That was 2 or 3 days ago?

Mr. SEIDMAN. Yes, sir.

Senator PROXMIRE. When a bank uses FASB-15, how is it determined that there is reasonable prospect of repayment? Is this determination made by the bank or must the regulator concur?

Mr. Clarke.

Mr. CLARKE. The determination is made by the bank.

Senator PROXMIRE. You don't have to concur?

Mr. CLARKE. That judgment would be subject to our review in the course of an examination, but the initial decision on how to restructure the loan and whether the prospects for repayment over the course of the restructured loan are good is the banker's decision.

Senator PROXMIRE. How does the banker know that his knuckles are not going to be rapped by the examiner later on?

Mr. CLARKE. He doesn't, but he also doesn't know that when he makes the loan in the first instance. We hopefully are not using bad judgment just as we hope the banker is not using bad judgment in evaluating his loan.

Senator PROXMIRE. Mr. Seidman, in your testimony you say there were 62 agricultural bank failures in 1985 and current trends suggest that at least for the next year farm bank problems and failures are likely to continue at levels at least equal to those experienced last year.

How much did these bank failures cost the insurance fund last year, and can you tell us about the overall health of the program?

HEALTH OF THE FDIC FUND

Mr. SEIDMAN. The overall health and condition of the fund is good. We will be announcing a net worth of approximately $18 billion, an increase of about $1.4 billion when we publish our statement. Those are our numbers.

This is despite the fact that we had a $1.3 billion loss on Continental, about $600 million on banks foreclosed in 1985, and since the farm banks were approximately half of that, something near $300 million was the cost of supporting the farm bank losses.

Overall, I think the fund has done exceptionally well under very difficult conditions.

Senator PROXMIRE. In your best judgment, can you tell me the number of agricultural banks that will fail in 1986 under the following three scenarios:

No. 1, Congress and regulators do nothing to change the current system.

No. 2, the regulators promote the use of FASB–15 and follow it with a capital forbearance policy wherever possible.

No. 3, the Congress enacts legislation allowing a 10-year loan loss deferral along the lines of the Dixon bill.

Mr. Seidman, first. The first one is nothing done.

Mr. SEIDMAN. We estimate that under current conditions 60-some banks, farm banks, will fail during 1986.

Senator PROXMIRE. Sixty?

Mr. SEIDMAN. Yes, sir.

Senator PROXMIRE. And suppose you used FASB–15.

Mr. SEIDMAN. It is very difficult to make an estimate, but undoubtedly there would be some banks that would be helped by that and the number would be lower. I cannot give you an exact number.

Senator PROXMIRE. How about the Dixon bill?

Mr. SEIDMAN. I think that would probably make very little difference as compared with using FASB–15 because we already are forbearing in capital requirements where we think the bank has the ability to recover.

Senator PROXMIRE. My time is up, and I don't want to impose the time of the other Senators who have been waiting. So let me just ask each of you, Mr. Clarke and Mr. Taylor, to give me those answers.

First, no action. What happens?

Mr. CLARKE. Our estimate, Senator, is the same as the FDIC's.

Senator PROXMIRE. And FASB–15 will save some banks. Can you give me some estimate of how many?

Mr. CLARKE. Under either of those two scenarios, Senator, it is very difficult, as Chairman Seidman said, to make a precise estimate. Our feeling is that in the short run you are not going to keep that many banks from failing under any of these scenarios because the banks that are failing today are the ones that are just flat out of capital. The ones we are trying to help are the ones that have underlying strength and need some time to work their way through the problem.

Senator PROXMIRE. Mr. Taylor.

Mr. TAYLOR. We have not traditionally estimated the number of bank failures, and I would have no reason to dispute the numbers given here.

To get to the body of the question, I don't think that either one of the other two proposals would significantly change the failures in the near term. Perhaps they are going to change it in the longer run.

Senator PROXMIRE. Thank you.

The CHAIRMAN. Before I turn to Senator Gramm, could I just ask, Mr. Clarke, if you would submit for the record a copy of your communique that went out to the banks announcing FASB-15?

Mr. CLARKE. I would be glad to do so.

[The following information was subsequently submitted for the record:]

B C-195

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Accounting for Restructured Loans and Sales of Foreclosed Property

To: Chief Executive Officers of All National Banks, Deputy Comptrollers, District Administrators, Directors and All Examining Personnel

PURPOSE

This issuance provides a summary of the accounting principles applicable to "troubled" debt restructurings and the sale of other real estate owned property (OREO).

BACKGROUND

The financial difficulties being experienced by many borrowers, particularly within the agricultural community, have necessitated the restructuring of loans to borrowers who are unable to meet current or near term contractual loan agreements. These restructurings may involve extending payment schedules; reducing interest rates, principal amounts or accrued interest; granting of additional credit (often in the form of a crop loan for the current year); or transferring property (land or equipment) to the bank in full or partial satisfaction of the debt. These difficulties may also result in foreclosures with the bank becoming the owner and subsequent seller of property.

Regulatory policy requires that debt restructurings be accounted for in accordance with generally accepted accounting principles. The authoritative accounting literature which governs these transactions is Statement of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" ("FAS 15"); Accounting Principles Board Opinion No. 21, "Interest on Receivables and Payables" ("APB 21"), and; Statement of Financial Accounting Standards No. 66, "Accounting for Sales of Real Estate" ("FAS 66").

ACCOUNTING

Troubled Debt Restructurings

FAS 15 establishes the accounting treatment for "troubled debt restructurings." The Statement defines a troubled debt restructuring as one in which the bank, for economic or legal

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Accounting for Restructured Loa
and Sales of Foreclosed Propert

reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. It is important to note that all restructurings do not meet this definition. For example, a loan which is extended or renewed at a interest rate equal to the current rate for new loans with similar risk would not be classified as a troubled debt restructuring even if the new rate is less than the previous rate. Therefore, only troubled debt restructurings meeting this definition are accounted for in accordance with the Standard.

Modification of Terms

If the new terms of the troubled debt restructuring provide for a reduction of either interest or principal (referred to as a modification of terms), FAS 15 requires that the recorded amount of the loan on the bank's books (principal plus accrued interest) be compared to the total future contractual cash payments (including both principal and interest) expected to be collected. A loss is recognized only if the total of such future combined payments is less than the recorded amount of the loan. Otherwise, no loss is recognized and the only additional accounting requirement is to determine the new effective interest rate for income recognition purposes.
See Examples 1 and 2.

New Effective Interest Rate

Often, the new effective interest rate is equal to the stated loan rate included in the restructured loan document. However, adjustments may be required if (1) the loan principal is reduced, (2) the new contractual rates are on a graduated basis (e.g. 8% first year, 10% second year, etc.), (3) due and unpaid interest is not added to principal or otherwise included in the contractual interest rate amount, or (4) the repayment terms have other unusual provisions. If an effective interest rate computation is required, it should be based upon future contractual payment terms excluding all payments which are contingently payable. This rate is calculated so as to yield a constant rate of interest over the remaining life of the loan. It is expected the rate will generally be less than the original loan rate and may be as low as zero without any requirement to recognize a loss. See Example 3.

One problem that does arise when a bank's capital is temporarily depleted is that its single borrower loan limit is reduced commensurately because this limit is based on a percentage of capital (15 percent in the case of national banks). Thus, although a loan may have been within the single borrower limit at inception, a reduction in capital that results from loan losses will lower the bank's loan limit, thereby precluding the restructuring of loans that are above the reduced single borrower limit. This would occur even though the absolute amount of the loan would not be increased. It is our view that if this problem could be dealt with and if the agencies would agree to utilize the provisions of existing generally accepted accounting standards as set out in FASB #15, it would not be necessary nor would there be any advantage to issuing net worth certificates or endorsing the deferral of loan losses.

Mr. Chairman, in your letter to Chairman Volcker you also asked for comment on the March 6 testimony of Charles Sethness, Assistant Secretary of the Treasury, and that of the ABA and IBAA. First, regarding Mr. Sethness's testimony, I believe it clear from my remarks that his views on the various proposals for assisting farm banks reviewed here today parallel those of the Board. On the other hand, the ABA and IBAA have endorsed the stretching out of loan losses over a number of years. The Board, as I reviewed earlier, has reservations regarding this approach, for the reasons I stated.

To sum up, it is clear that a substantial number of farm families and farm banks are experiencing difficulty of greater or lesser degree at the present time. In light of this situation, the Board believes that the Congress and the banking agencies should take actions that will provide assistance to the agricultural sector while, at the same time, not undercutting

effective and appropriate supervision of and accounting for the activities of farm banks. In particular, the Congress and state legislators could make a much needed contribution by helping to maintain the provision of banking services to small communities. The Garn-St Germain Act of 1982 presently prohibits acquisitions of troubled banks across state lines before they have failed and acquisitions of failed banks with assets under $500 million. The banking agencies believe that these two constraints should be eased by allowing failing bank acquisitions across state lines and by reducing the size criterion so as to maintain the banking services in farm communities. An easing of state restrictions on branchings could also help maintain banking services in small towns in cases when a separately organized and capitalized bank might not be viable.

There are also important things that can and should be done by the banking regulators in these difficult times.

1. Reaffirm the policy of not discouraging banks from exercising forbearance on farm loans that are being restructured when there is a reasonable prospect that this will work to the mutual benefit of the bank as well as the borrower.

2. Consistent with this general policy on forbearance the agencies should be forthcoming in applying the principles of FASB #15. That is, the agencies should not require that a loss be recognized on a farm loan unless the anticipated cash receipts of the restructured debt are insufficient to cover the principal amount of the loan.

3. Also, in keeping with the spirit of that approach the agencies should modify regulatory reporting requirements so that loans appropriately restructured, no longer need be classified as nonperforming loans.

4. The single borrower limit should be changed or interpreted to prevent restructured loans from being held in violation of the limit based solely on the temporary decline in the bank's capital.

5. The agencies should offer a clear statement of their intention to employ a simple policy of capital forbearance.

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Accounting for Restructured Loa and Sales of Foreclosed Propert

Acceptance of Property

If the bank accepts property (i.e. farm land) in full satisfaction of the loan, the property should be written down and recorded at its fair (appraised) value. The difference between the recorded amount of the loan, including recorded accrued interest, and the fair value of the property received should be charged to the allowance for loan losses. Any future writedowns of the property should be charged against operations.

Restructuring with Acceptance of Property

A restructuring may include both a modification of terms and the acceptance of property in partial satisfaction of the loan. The accounting for such a restructuring involves a two step process. First, the recorded loan balance is reduced by the fair market value of the property received. Second, the modified payment amount is compared to the remaining recorded loan amount as explained under "modification of terms" above. See Example 4.

New Loan

The bank may extend additional credit to a borrower at interest rates below the current market rate. An example would be a new crop loan extended to give a borrower an opportunity to return to profitable operations. Since this is a new loan to the same borrower, no special accounting rules apply. Accordingly, discounting or loss recognition is not necessary. However, if the new loan is granted in connection with the restructuring of an existing loan, it will be considered part of the restructuring and accounted for as previously described.

Credit Analysis

In all troubled debt restructurings the collectibility of future payments may be questionable. Therefore, a credit analysis should be performed to determine if any additional amounts should be charged to the allowance for loan losses. The analysis should include the borrower's ability to meet the new terms of the loan based upon projected cash flows, profitability and other credit factors.

BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type: Banking Circular

Subject: Accounting for Restructured Loar and Sales of Foreclosed Property

Sale of Foreclosed Property

The sale of foreclosed property (i.e. farm land, etc.) will often be financed by a loan made at less than current market interest rates. In this situation, APB 21 requires that the loan be discounted to bring its yield to a market rate. The effect of the discount will then be to either increase the loss or reduce the gain which results from the sales transaction. Interest income is then recognized at a constant yield over the life of the loan.

Banks may also facilitate the sale of foreclosed property by requiring little or no downpayment. In these circumstances the required accounting is set forth in FAS 66 (also see Interpretative Ruling 7.3025). In general, any profit must be deferred on sales of farm land with downpayments of less than 25% of the discounted (if required) sales price. Losses, however, should be recorded immediately. See Example 5.

This Circular is only a summary of the accounting principles which apply to troubled debt restructurings and the sales of foreclosed property. In determining the appropriate accounting for a complex transaction, reference should be made to FAS 15, FAS 66 and APB 21.

ORIGINATING OFFICE:

Questions regarding this Banking Circular may be directed to the Chief National Bank Examiner's Office, Bank Accounting Division (202) 447-0471.

H. Joe Selby
Senior Deputy Comptroller
for Bank Supervision

Date: May 1, 1985

Example Assumptions:

The following examples assume that the loan or a portion thereof was not charged off prior to the restructuring. If a charge-off was required, it should be recognized before the restructuring computation set forth in these examples.

Example 1 - Interest Rate Reduced

A borrower who owes the bank $125,000 is experiencing financial difficulty. The bank agrees to reduce the interest rate from 15% to 4%. Principal and interest payments are due in one year.

Contractual principal payment	$125,000
Plus: Contractual interest payment	5,000
Total cash payments expected	130,000
Less: Loan amount	125,000
Difference	$ 5,000

No loss is recognized since total contractual payments ($130,000) exceed recorded loan amount ($125,000). Interest income of $5,000 will be recognized at the stated 4% rate.

Example 2 - Principal Reduced With Loss Recognition

A borrower who owes the bank $125,000 is experiencing financial difficulty. The bank agrees to reduce the loan to $100,000. The interest rate will be 12.5%, with principal and interest due in one year. In this situation the bank will record a $12,500 loss, computed as follows:

Original recorded amount of loan	$ 125,000
Less: Contractual principal payment	(100,000)
Less: Contractual interest payment ($100,000 at 12.5%)	(12,500)
Loss (cash deficiency)	$ 12,500

The loan will be recorded on the bank's books at $112,500 rather than the contractual amount of $100,000. This is the original

recorded amount of the loan reduced by the loss. No interest income is recognized since all payments will be applied against the recorded amount of the loan.

Example 3 - Principal Reduced With No Loss Recognition

A borrower who owes the bank $125,000 is experiencing financial difficulty. The bank agrees to reduce the loan to $100,000. The interest rate will be 12.5%. Interest will be paid annually and the principal will be due in three years.

In this situation there will be no loss (assuming the loan or portion thereof was not charged off prior to the restructuring) since the total future principal and interest payments will exceed the original book value of $125,000. In addition, the bank will recognize $12,500 (at a 3.57% rate) of interest income over three years, computed as follows:

Contractual principal payment	$100,000
Plus: Contractual interest payments ($100,000 at 12.5% for 3 years)	37,500
Less: Original recorded amount of loan	(125,000)
Interest income	$ 12,500

Since no loss is recorded on this transaction, the loan remains on the bank's books at its original balance of $125,000, rather than the contractual amount. The new effective interest rate is based on the recorded amount of the loan. An interest rate of 3.57% will yield a constant rate of return over the life of the loan in relation to the outstanding book balance. Accordingly, approximately $4,500 of interest income will be recognized in the first year.

Example 4 - Principal Reduced and Property Accepted

A borrower who owes the bank $125,000 is experiencing financial difficulty. The bank agrees to accept land with a fair market value of $15,000 in partial satisfaction of the loan. In addition, the loan is modified. Under the modified agreement the customer will repay $100,000 of principal in one year and $10,000

will be forgiven. Interest, at the reduced rate of 5%, will also be paid at that time. In this situation the bank should record a $5,000 loss, computed as follows:

Original recorded value of loan	$125,000
Less: Fair market value of property accepted in partial satisfaction	(15,000)
Adjusted loan amount	110,000
Less: Future principal	(100,000)
Less: Future interest ($100,000 x 5%)	(5,000)
Loss	$ 5,000

If the interest rate was 10%, the bank would recover its entire investment and no loss would be recorded (assuming the loan or a portion thereof was not charged off prior to the restructuring). No interest income would be recognized since all payments would be used to satisfy the recorded amount of the loan. If the interest rate was 15%, the bank would recover $5,000 more than the recorded value of the loan. This amount would be recognized as interest income over the life of the loan. The computation would be as follows:

Future principal payment	$100,000
Plus: Future interest payment ($100,000 at 15%)	15,000
Less: Adjusted loan amount	(110,000)
Interest income to be recorded over the life of the loan	$ 5,000

Example 5 - OREO Sale Financed

The bank owns a tract of foreclosed farm land which is recorded on its books as Other Real Estate Owned in the amount of $85,000. The land is sold for $110,000 with the bank financing $100,000 of the purchase price. A $10,000 downpayment is received. The contractual interest rate on the loan is 6%. Principal is due in five years, and interest is paid annually. The market interest rate for similar debt is 14%.

APB 21 requires that the loan be discounted to its present or fair market value. The present value of this loan, discounted to yield a market rate of 14%, is $72,535. Therefore, the adjusted

sales price of the property is $82,535 ($10,000 + $72,535). The loss on the sale of the property is computed as follows:

Recorded amount of land	$ 85,000
Less: Downpayment	(10,000)
Less: Discounted value of loan	(72,535)
Loss on sale of land	$ 2,456

The loan discount is recognized as income over the life of the loan. It is computed as follows:

Face value of loan	$100,000
Less: Discounted value of loan	72,535
Loan discount	$ 27,465

Since the land was sold at a loss, the entire amount of that loss is booked. Note, however, that had the sale resulted in a gain, FAS 66 would have required that it be deferred because the downpayment was less than 25%.

Additional Example Factors

The above examples illustrate the proper application of generally accepted accounting principles. These illustrations should not be interpreted as preventing additional loan charge-offs or provisions to the allowance for loan and lease losses based upon credit analyses performed by the bank's management or regulatory agencies.

The CHAIRMAN. Mr. Seidman, I understand the FDIC was originally opposed to FASB-15 but you reversed your position on that. Do you have any written communications which you could supply for the committee on your initial opposition and then your reversal of position?

Mr. SEIDMAN. I will get you all the material that we have on that.

Mr. CLARKE. Mr. Chairman, before Senator Proxmire leaves——

The CHAIRMAN. He is fast. He runs. [Laughter.]

Senator PROXMIRE. I beg your pardon?

Mr. CLARKE. Senator, I just wanted to make sure before you left that I had not misled you at all with respect to the rapidity with which we can implement these policies. In terms of our preparedness to implement them, we can do it this afternoon. There are two technical matters, however, that have to be resolved. One, as you heard us say earlier, is the change in the call report. As you know, we use a uniform call report that has been approved by the Federal Financial Institutions Examination Council. Fortunately, the Council's meeting for this quarter is on Friday, and we can put that on the agenda. It is a very minor change to the call report, but it still has to go through the Council. I assume everyone will approve it without any problem.

The second technical matter concerns the loan limit. We need to make certain that our regulations defining capital adequately cover the forbearance concept. It may well be that those regulations have to be amended. But that is simply a matter of publishing any change for comment on an emergency basis, and I would think that could be done within a 30- to 45-day period.

Senator PROXMIRE. As far as the farmers are concerned, 30 to 45 days then until the whole effect is felt?

Mr. CLARKE. Until you actually have a regulation in place. It seems to me, though, that announcing our policy, subject to the time periods of notice, would in itself begin to create a favorful atmosphere for both banks and borrowers.

Senator PROXMIRE. Thank you.

The CHAIRMAN. Senator Gramm.

Senator GRAMM. I have discussed with Mr. Seidman and Mr. Clarke our plight in the energy industry. As I see it, we have two sick industries. The agricultural industry is sick, because of misguided Government policy which encourages overproduction and impoverishes good and bad farmers alike. This will not change that policy and, therefore, the illness is going to continue in the countryside.

Our second problem is that we've got a collapse in world oil prices, and a result, we have a lot of loans and a lot of companies that are well-managed and have a capacity to work out from under those loans. We have a lot of good banks that made good loans when oil prices were $30, and at $15, those prices are not so good. So I think there is a parallel between the two industries.

And since we're talking here about implementation of a policy by Friday afternoon, I'd like to go beyond the chairman's question and simply ask, do I have a commitment today that when this policy is implemented, and hopefully, we can make the Friday afternoon schedule, that any actions taken in terms of allowing the restruc-

turing of debt and doing it in such a way as not to categorize those loans as nonperforming, that any action that is taken under capital forbearance will apply equally to energy on the basis of the problems that exist in that industry on a local or national basis, as it applies to agriculture.

If I could, let me start with Mr. Seidman and simply go down the line.

Mr. SEIDMAN. As I said, Senator, of the three things that we're talking about, two, I think, should apply uniformly to all institutions. The one that would raise questions about being industry-particular would be the capital forbearance. We are currently in process with others of making a study on the effect of prices on the banking system. It seems to me, if that shows that there's going to be a situation in energy comparable to agriculture, that that tendency should be covered.

I haven't seen the final result of that study, but an early look at it indicated that it would show an industry in trouble and in need of help in the same way agriculture is.

Senator GRAMM. So we are looking at what kind of timeframe? If this committee should decide not to report legislation or allow to carry out the policy you've outlined here today, then in listening to you, we are going to have action related to agriculture, which is already underway.

When is similar action going to be related to energy? For example, we have an FDIC office in Midland, Odessa, in the Permian Basin, and that area is greatly depressed. When would the policy be implemented there?

Mr. SEIDMAN. Just as soon as we could make the determination that the energy industry loans in that industry require such action. I don't know when the survey which is being made jointly by all regulators will be completed, but I am sure it could be completed within the next couple of weeks.

Senator GRAMM. If I could, let me have from you at least any preliminary findings of that study, what the timetable is and let me urge you to proceed on that very rapidly. Mr. Clarke?

ISSUING GUIDELINES ON A BROAD BASIS

Mr. CLARKE. Senator, I would think that the three agencies ought to sit down and make a final determination as to whether we would be prepared to issue any capital forbearance guidelines to institutions on a broader basis than just agricultural banks before we actually put any guidelines out. If we are going to make them apply across the board, it would be much simpler just to have a broadly based issuance to the banks.

Senator GRAMM. Let me say, Mr. Clarke, that I agree with that, and I would hope you could issue the guidelines to apply across the board, specifically mentioning the problem areas of energy and agriculture, because I think you have a special circumstances in both those industries, because you have geographic concentration. You have oil-producing areas that are totally dominated by the market for crude petroleum. You have agricultural areas that are totally dominated by the market for agricultural products. So you're going to have a regional concentration of these problems, and it seems to

me that one policy that is applicable to depressed areas and depressed industry when related to the classification of restructured loans and related to the capital forbearance makes sense. I hope we can do them both at once. Mr. Taylor.

Mr. TAYLOR. I don't really have a different answer.

Senator GRAMM. If I may, Mr. Chairman, let me just sum up with a statement. I think it is clear that we do have a problem in both energy and agriculture. It is my intention to see that whatever policies apply to one apply to both. I think that reserves, as I learned in my money and banking class and as you learned, are to be used on a rainy day, and I think the rainy day has come. It's raining like hell out there in the agricultural areas of the country and in the energy areas. And I think at a time of crisis like this, it is time for the regulators to be bold and for Congress to be cautious. And I want to urge you to act immediately, use your full powers to act, and we may find it to our advantage, both to stop bad things from happening and to strengthen your actions to come out with a bill that basically sets out in the law, the guidelines that you intend to implement anyway and possibly with some marginal strength.

I, for one, am very concerned about net worth certificates. The whole strength of our financial system depends on real capital not phony capital. Whether the capital comes from Government or from phony books, the net result is the same. I think the capital forbearance idea, especially if applied aggressively, can do more good without risking the harm that we can have by going to net worth certificates or by setting a writeoff period that makes no sense whatsoever economically and that imperils the whole FDIC and the whole national banking system.

Let me further say that I feel very strongly on international loans and on domestic loans, that the problem is primarily one between the lender and borrower and that the regulatory agency ought to try to facilitate their solving of their problem.

I am opposed to any mandatory debt restructuring. I think banks ought to make the decision, and I think that you ought to require in the regulatory process, that while the restructured loan should not be classified as nonperforming, and if the full face value of the loan can be paid off, that it ought to count on an equal par with the current loan, but I think that it's vitally important that we continue to take action to help these two ailing industries without weakening the entire financial structure of the country, and I think it is important for those of us in Congress, as we hear a lot of these popular ideas that are being floated to have the Federal Government come in and to bail out either foreign lenders or domestic lenders, that we try to be responsible and work with you.

That's what I hope that we can do. I guess it is my feeling that there is so much support for action that it probably behooves us to do something and to try to follow some of the guidelines that you've set out here, and while you have been slow to act, that does not mean that we ought to throw out the good ideas that you have now for action. I hope you will follow up with the setting out of your policy related to agricultural and energy, and I hope you report to me on that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Gramm.

I now have before me a joint statement of the Fed, the FDIC, and the Comptroller. I would include that in the record.

[The statement of the Fed, FDIC, and the OCC follows:]

Joint Statement of the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency on Regulatory Policies Toward Agricultural Lenders

The Federal bank regulatory agencies are fully aware of the problems in the agricultural sector of our economy and the financial strains these problems have created for borrowers and lenders. In light of these conditions, the banking agencies believe it appropriate to employ supervisory policies that will assist basically sound, well-managed banks to weather this transitional period, consistent with the need to maintain an adequate supervisory framework and the credibility of regulatory and public financial statements. Supervisory and regulatory policies to help achieve these objectives are outlined below.

In addition to the regulatory policies contained in this statement, the banking agencies continue to urge the Congress and state legislatures to take steps to help maintain the provision of banking services in small communities. The Garn St Germain Act of 1982 prohibits acquisitions across state lines of troubled banks before they have failed and of failed banks with assets under $500 million. The banking agencies believe that these two constraints should be eased by allowing failing bank acquisitions across state lines and by reducing the size criteria so as to maintain the banking services in farm

communities. An easing of state restrictions on branching could also help maintain banking services in small towns in cases when a separately organized and capitalized bank might not be viable.

In order to help alleviate strains on farm lenders and provide additional time to resolve problems in the agricultural sector, the banking agencies express their support for and commitment to the following supervisory policies and principles:

- A major function of capital is to absorb unanticipated losses and help an organization weather a period of adversity. Heavy losses may reduce a bank's capital below normal levels or below minimum regulatory guidelines. The banking agencies will allow a bank experiencing difficulties to operate below the minimum capital requirement provided the bank has the capacity to restore capital within five years.

- The banking agencies reaffirm their policies not to discourage banks from forbearing on farm loans through appropriate debt restructurings, recognizing that such restructurings may be in the interests of both the bank and the borrower when there is a reasonable prospect that the borrower will eventually be able to repay the loan.

- Consistent with their general view toward forbearance, the banking agencies will continue not to require an automatic charge-off of loans that have been restructured. Generally accepted accounting principles, as set forth in Financial Accounting Standard No. 15 (Accounting by Debtors and Creditors for Troubled Debt Restructurings), allow financial institutions to maintain the value of a restructured credit provided that the total of anticipated future cash receipts under the new modified terms which are both probable and can be reasonably estimated at least equals the principal value of the loan. Thus generally accepted accounting principles do not necessarily require the immediate charge-off of loans or portions of loans that have been restructured in accordance with that rule.

- The banking agencies see no compelling reason for interpreting or reporting renegotiated debt with nonperforming loans. In line with this view, the agencies propose to modify regulatory reporting and disclosure requirements for restructured debt so that such debt, if it is performing in accordance with the new terms, would be designated as loans "Restructured and In Compliance With Modified Terms."

The CHAIRMAN. Senator D'Amato.
Senator D'AMATO. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR D'AMATO

Today, we continue our oversight of the effect the farm crisis has had on financial institutions engaged in agricultural lending. At my request, the bank regulators undertook an analysis of the situation and submitted options as to how they and the Congress might ease the strains resulting from such lending commitments. The focus of this hearing will be to explore the specifics of the regulators' reports.

As I indicated at last week's hearing, after completion of the hearing process it is my intention to work toward markup of a proposal to assist farm banks and borrowers through this transition period. The contents of such a measure have yet to be determined. There is a general understanding among interested parties that we should work to develop a consensus package which addresses the problems effectively and responsibly but avoids becoming a legislative Christmas tree. Furthermore, Senator Dole has pledged his willingness to schedule floor time for our effort.

Last week's hearing produced a fruitful discussion and valuable insight on some credible suggestions. I expect more of the same from today's hearing. Today we will hear from William Seidman, Chairman of the FDIC, Robert Clarke, Comptroller of the Currency, and Preston Martin, Vice Chairman of the Federal Reserve. Mr. Martin will be accompanied by William Taylor, Director of Bank Supervision at the Federal Reserve. We will begin with remarks from other Members who share our concern over this issue but do not serve on the Banking Committee, including Senators Nickles, Melcher, and Exon.

Mr. Chairman, I certainly hope that the recently sworn in Secretary of Agriculture will expedite the appointment of a three-member governing board of the Capital Corporations, so that we can get the restructuring at the FCA—that's the Farm Credit Administration—which is so desperately needed. I want to suggest to you that it is absolutely shameful that that has not taken place. We in New York may not be seen as an agricultural State. The fact of the matter is, that's probably our largest industry, that employs directly or indirectly, some 400,000-plus people. It is estimated that we are going to have something in the area of a 29-percent reduction and lose some 7,000 farms within the next 3 to 4 years.

So, we are obviously very much concerned. People tend to think of New York simply as Manhattan, subways, high rise and they fail to recognize the great diversity of the State in the agricultural areas that are similarly depressed.

INTOLERABLE DELAYS ON RELIEF

I have to ask you, Mr. Seidman, why did the FDIC not permit the institutions under their jurisdiction to use FASB-15? What was the reason for their not allowing that? And what was the reason for the change in FDIC's position?

Mr. SEIDMAN. Senator, I wasn't with the agency. They didn't permit its used until a specific instance came along of the 90-10

Government program for guaranteeing farm loans. So, they had a somewhat ambiguous record. Since I wasn't there, I don't know what the reason was in not allowing it in that specific instance.

Senator D'AMATO. Mr. Clarke, were you aware of any reason why? I mean, you were all working together in this.

Mr. CLARKE. No, sir. As I say, we were applying it and do have an issuance out as to its use.

Senator D'AMATO. Of course, you know, the question's got to be as Senator Garn noted—I think Mr. Taylor indicated regarding reason why the change was made.

Mr. Clarke, let me ask about the implementation of this account. Did you say in your answer to Senator Proxmire that you're really talking about publication data? It will take 30 to 40 days before FASB–15 can be implemented or be used?

Mr. CLARKE. No, sir, not to implement FASB–15. Use of FASB–15 is permitted right now. We have an issuance out in the hands of all the bankers to that effect.

Senator D'AMATO. On the restructuring, debt restructuring? Is that what you're talking about?

Mr. CLARKE. Yes, sir. That's what FASB–15 is all about.

Senator D'AMATO. Well, let me suggest to you that it would seem to be that whatsoever is calling tune, whether it's the Treasury that coordinates your activities, whether you've done it to come together, I don't know, on your own. I'm not going to ask you to tell us who. You probably wouln't tell us anyway, but you've done a poor job.

I can't believe that we have to experience this kind of pain, before you people would urge the application of FASB–15.

And Mr. Taylor, I want to tell you something. When you say I have nothing but poor choices, we understand it is a difficult time, but I'd like to ask you what would you think the Congress should do, and if we didn't do this, what would you have done? Nothing? And is that the kind of choice that we leave the farmers with or that we leave the banking institutions with, and their failing would then take place?

What would you do, Mr. Taylor?

Mr. TAYLOR. Senator, I should maybe have prefaced my former remarks by saying what we have done. Maybe I should go over that. We have some 2 years ago started a program whereby we look at the farm situation in a special way. We have instructed our examiners not to discourage debt restructuring. We've told our examiners not to classify, not to require chargeoffs where value protects. In other words, if you have a potential or turnaround of a loan, either from cash-flow or through value, that one is not to treat that harshly.

In addition, we have a senior official at each Reserve bank review the bank examination of each agricultural bank, as it is completed, to assure that the policies are followed. The question of choices rally relates to trying to maintain some integrity in the financial statements of the Nation's banks, while balances of against that, a serious concern that we, by our policies, not prejudice the abilities of the farmers to recover, along with the bank.

Senator D'AMATO. I am simply going to say that I just think it is really inexcusable that it taxes a legislative initiative by the Con-

gress that obviously takes it a much greater period of time to get the kind of movement in this area that was long overdue. It is inexcusable to both the institutions, to those farmers that find themselves in distress, wherever, by implementation of the debt restructuring, FASB–15, et cetera, where those things can or should have been done before.

I am just wondering why it took you so long. That's it. Why did it take you so long?

Mr. CLARKE. Senator, If I could——

Senator D'AMATO. I mean, if what you're doing is the right thing now—maybe it's not, but if what you're doing in your program in this wonderful statement that we just get now, if what you are doing is right, why did it take so long for you to come up with it?

Mr. CLARKE. As I indicated earlier, making a change to provide for capital forbearance is not something that one does lightly. We want to make sure that the long-term implications of what we are doing are not more negative than positive.

Since being sworn in on December 2, I have participated in at least a dozen meetings, some of which have been with the other bank regulators, some of which have been with industry representatives, trying to come up with acceptable proposals. That is the genesis of a lot of the ideas that have been presented to the committee. So, we have been working at it; we have not just been sitting back waiting for somebody to hold a gun to our heads and demand that we take action. We would not be in a position to implement the things we're talking about implementing today unless we had given a great deal of thought to these issues over the past months.

Senator D'AMATO. I think we owe a great debt of gratitude to the chairman of the Banking Committee, No. 1, for using these hearings as an opportunity to present legislation, which I think will play a key and indispensable role in moving us forward and moving you gentlemen forward at least to putting forth a program that possibly will help in terms of restructuring and giving banks an opportunity to continue helping the framers and in the areas of energy; because I have no doubt, unless Senator Garn has called these hearings and had unless we held hearings on Senator Dixon's proposals these recommendations wouldn't have been made today.

This didn't just miraculously show up at the time that you gentlemen were supposed to testify.

So, Senator, let me thank you and commend you on behalf of those small banks, those agricultural banks.

The CHAIRMAN. I would say in the witnesses' defense, earlier, before you got here, I asked them the same question.

Mr. Taylor said it very diplomatically.

Senator D'AMATO. I don't have to be diplomatic. [Laughter.]

The CHAIRMAN. We acted as some form of catalyst to encourage them to go ahead.

Senator D'AMATO. Well, we owe you, and I think the small farmer, Mr. Chairman, and those banks who can make it as a result of this kind of restructuring that should have begun, should be undertaken, I have to respectfully disagree with our new Comptroller; that probably should have been done before you got there.

This hasn't been a crisis that's come about in the last month, or 2 months, or 3 months. We've got people just out there in this terrible, terrible crisis and the regulators need our prompting instead of trying to get somewhat ahead of the problem.

I remember, when I first came in 5 years ago, they were laughing at the thrifts, particularly those in New York that had problems. No one's laughing now, and it's spread throughout the country—net worth certificates in certain cases were the answer.

They kept very calamitous situations from taking place. Not in respect to one particular institution or particular region, but that would have shaken the very foundations of the entire financial network system in this country.

It's very good for some people to say that net worth shouldn't at any time be used or applied. It would be terrible.

But, if you go back to 1980, I think this committee, and I think the Congress did what was absolutely essential.

But I have to again suggest that I would hope that we wouldn't take such a laissez fair attitude as it concerns some of these institutions that do need this kind of treatment.

Better late than never, I commend you for coming forth with it. And I hope you pursue it vigorously.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

IN TIME FOR SPRING PLANTING

Gentlemen, a great deal has been said about timing, and a lot of references to spring planting. What is your opinion? Can you establish a capital forbearance plan quicker so we can go ahead with legislation that will result in more farmers getting loans for their spring planting?

Mr. Seidman.

Mr. SEIDMAN. Mr. Chairman, first, on the matter of capital forbearance, I think I've heard from my two compatriots here two different kinds of plans. So, either we'll have different kinds or we'll need to agree which one of the plans is best.

I find that any of those really work out pretty much the same, whether you put on the books or simply lower the requirements. In the end, it's a paper transaction, not a money transaction, and has the effect of allowing operation at lower capital than normal.

But I do think we ought to be encouraged to agree upon something and, frankly, from our point of view, either one of those plans is acceptable. It seems to my view that they both do about the same thing.

As soon as we can get those and we can look at how we want to apply them, and we can put them in place, I shouldn't think that will take very long.

The CHAIRMAN. The reason I asked the question, obviously, is there has been a great deal of discussion here about are we just helping banks, or does that result in help down at the farmers.

And if it were January, the urgency would not be here. But if we want to help farmers, we've got to do something that allows the banks to restructure—loan loss deferral, or whatever. And be able to make loans for this spring's planting.

I'm simply asking a timing question at this point, not whose plan is best. But, can you move forward rapidly enough to have some impact on the spring planting?

Mr. CLARKE. Yes; as we have said, two of the three elements in our proposal are already in place. They require nothing other than our reiteration that FASB-15 can be used to help in the restructuring.

The capital forbearance proposal, requires, we believe, a minor modification to our regulation defining capital to make sure that the loan limits currently available to banks are still in place and can be used despite those restructurings. Publication of that regulation, even if it's done on an emergency basis, will take some time. That does not detract from the fact that our policy will be publicly known by bankers and borrowers.

The CHAIRMAN. Personally, I would prefer regulatory action rather than legislation. And the better and more rapidly you go ahead with what you have the ability to do on a regulatory basis, the less likely it is that we get into areas of legislation that you may not like.

So, I'm putting the monkey on your bank and saying if you don't like some of the legislative proposals, your best defense against those is to do your job as rapidly as possible, with some beneficial results that put seed in the ground.

I expect we will have legislation of some type, but I don't want to get in any bailout programs or have big amendments on the floor with my colleagues competing to see who can have the biggest amendment here or there, and run home and take credit for it.

I used to have a sign on my desk saying: "Results are the only excuse for activity."

We've heard some favorable comments on what you're doing. I don't know that it's important that we establish why you haven't done it in the past, I'm simply saying the time is now.

I'm not a farmer. When the sun starts to shine, then you put seed in the ground. That's about all I know about it, but it seems important that you move and that will have an impact on what kind of legislation we produce out of this committee within the next couple of weeks.

Mr. Taylor, do you have any further comments?

FED GUIDELINES

Mr. TAYLOR. Mr. Chairman, the only thing I would say is, at the Federal Reserve, we do not have the capital regulations, so there's no regulation to change. We have a guideline.

To answer your question: If the banker were to come to us today and say, "As a result of restructuring, my capital is going to go below the minimum, and I can show you over some reasonable time—4, 5 years, whatever it might be—that I can reestablish that capital, given the time, and I have a viable business here," we would buy that this afternoon.

Second, on the FASB-15, if a bank and a borrower got together and decided that they would restructure, and they convinced our examiner that, indeed, the amount equal to the principal could be repaid over the term of the loan, we would buy that this afternoon.

I'll admit that we're going to have to take a period here to make sure we provide some pretty close guidance for our examiners. And we set out to do that right away.

But I think we're ready to do these things. And, in fact, many of these have been in place. They just need implementing.

The CHAIRMAN. I thank you all. My point was just, strongly, the old cliche, that: "The best defense is a good offense."

And if you don't like some of the things Congress might do, rather than complaining about them, the good offense is a much better defense.

Thank you very much. The committee is adjourned.

[Whereupon, at 11:35 a.m., the hearing was adjourned.]

[Additional material for the record follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION
BEFORE THE SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE
WITH REGARD TO AGRICULTURAL CREDIT

March 11, 1986

Mr. Chairman, Farm Bureau appreciates the opportunity to present our views on agricultural credit.

For the past five years, agricultural finance policy has been driven by the "one more year" syndrome. The goal has been to keep borrowers and lenders solvent for one more year in the hope that the debt/income situation would correct itself. Since farm operators and lenders are partners and one cannot survive without the other, actions were taken on the assumption that anything that would help one would help the other.

This "one more year" policy was based on the idea that the debt problems of agriculture were caused primarily by forces beyond the control of the farm operator. Once these outside forces, like high interest rates, strong dollar, low exports, declining land prices and high production costs went back to "normal," everything would be okay. These outside forces are not at the root of the debt problems and changes in these forces will not relieve the debt pressures.

Agriculture has run out of "one more years." As a policy, that approach is now bankrupt, no pun intended. Those short-term lenders who have loaned money on equipment and livestock to pay interest and principal on land have said, "No more." Most operators are reluctant to further mortgage land to cover unpaid operating expenses.

Operators with the greatest debt problems have substantial amounts on nonworking debt that require the servicing of principal and interest but provide little cash flow to the business.

For 1986, the agricultural finance policy debate will be focused on the immediate problems of the one-third of commercial agricultural operators that hold two-thirds of the debt held by farm operators. About half of this group, 100,000 to 125,000 farm operators, are at the point where substantial debt restructuring will be needed over the next two years to avoid liquidation, either voluntary or forced.

A substantial reduction in debt loan or a reduction in the debt that has to be serviced out of current income is absolutely essential. Only this will bring long-lasting financial relief to stressed farm operators. For some portion of the farm operators, no reasonable amount of debt relief will be sufficient to deal with their debts.

Just how much debt reduction assistance will be available will depend on the resolution of some broad agricultural finance structure issues. How banks are forced to classify loans and for how long they are allowed to write off loan losses will determine how much debt restructuring they can provide farm operators.

Commerical banks currently face substantial regulatory impediments if they want to help farm operators with debt difficulties. Any debt restructuring that makes a portion of the loan a nonearning asset for the bank results in the nonearning portion of the loan immediately being written off against capital, even if the loan could be repaid at some time in the future.

Banks are also under increased pressure to require that loans be fully collateralized based on liquidation value of assets, even though the borrower has never missed a payment and continues to have a positive cash flow. This results from their mistake in focusing on asset-value lending rather than profit-and-loss lending. The focus is on liquidated value of the assets rather than the earning power of the debt.

Our goal is to develop a debt restructuring plan to aid financially stressed farmers who, under the right circumstances, have the chance to survive.

The American Farm Bureau Federation is proposing a Two-Tier Debt Restructuring Program to deal with long-term financial problems.

The program would start by having the farm operator and the lender analyze the individual operation to determine how much debt could be paid under normal circumstances. That would become Tier 1 debt. On this Tier 1 portion of the debt, the farm operator would pay the regular interest and principal payments over 10 to 20 years. The remainder of the debt would be put into Tier 2, where it would carry an interest rate of 3 percent with no principal payments. As a portion of the Tier 1 debt is paid off annually, debt would shift from Tier 2 to Tier 1 until all the two-tier debt is paid.

To give you an example, you have a $300,000 debt, and after an analysis, the banker and borrower decide that $200,000 can be properly serviced; that becomes Tier 1 and the remaining $100,000 becomes Tier 2 debt.

The key is debt restructuring--not debt forgiveness. Financial institutions do not have enough capital base to forgive substantial amounts of debt.

Some steps are necessary to make the program work. Tier 2 debt must be monitored separately by regulatory authorities so that it is not discriminated against or classified against the capital of the financial institution. This will require the approval of the proper regulatory authorities such as the FDIC and Comptroller of the Currency for commercial banks and the Farm Credit Administration for the Farm Credit System. While we believe our two-tiered debt restructuring legislation can be accomplished via changes in regulations, Farm Bureau is in the process of drafting legislation to accomplish the goal too.

In addition to the Two-Tiered Debt Restructuring Program, Farm Bureau is also supporting S. 1943, introduced by Senator Dixon, which allows banks to change the way they write off their capital losses from one year to up to ten years. This flexibility on the part of bankers is crucial in dealing with the present farm financial crisis.

Through the restructuring process, we encourage farm borrowers, lenders and the regulatory agencies to shift their emphasis from asset-value lending toward greater emphasis on profit-and-loss or cash-flow procedures.

In our judgment, such a plan represents a realistic approach to turning the debt problems around. This plan can create more winners than we could otherwise expect from a continuation of our current efforts. Asset values will stabilize, fewer farmers will be forced out of business and banks will benefit from stronger loan holdings.

Mr. Chairman, we appreciate the opportunity to present our views to the Committee.

National Governors' Association

Lamar Alexander
Governor of Tennessee
Chairman

Raymond C. Scheppach
Executive Director

STATEMENT OF

THE HONORABLE TERRY BRANSTAD

GOVERNOR OF IOWA

before the

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

ON

AGRICULTURAL FINANCE

March 11, 1986

HALL OF THE STATES · 444 North Capitol Street · Washington, D.C. 20001-1572 · (202) 624-5300

Mr. Chairman, we are here this morning to express our strong concern over the financial condition of agricultural lenders in a time of farm stress. Governors continue to be on the front lines of the agricultural finance crisis. We commend this committee for holding hearings on this problem. I would like to address three issues in my statement which Governors believe are important in your deliberations:

- o the Governors' position on agricultural finance
- o the current fiscal condition of farm-belt states
- o the importance of prompt Congressional action for agricultural banks

Agricultural Finance Position

The basic problem facing farm lenders is five consecutive years of a weak farm economy. The outlook for the agricultural sector in 1986 promises to be as bleak as 1985 with net farm income projected to be between $21-$25 billion while in 1981 net farm income was $29.8 billion. Whereas, farm debt rose in proportion to high real farm income and escalating farmland prices in the 70s, the dramatic decline in these income and asset measures experienced in the 80s has led to the loss of nearly $250 billion dollars in farm equity in the last 5 years.

The Council of Economic Advisors 1986 Annual Report reports the magnitude of adjustments that agriculture faces: farms lost $111 billion in farm equity after capital gains in 1984.

The financial stability and public confidence in the agricultural banking system has been shaken with the following recent reports:

- o The Nation's largest financial losses were reported by the Farm Credit System in February 1986 at $2.69 billion for 1985 .
- o More than half of all bank failures in 1985 were agricultural banks (68).

Government direct and guaranteed loans and sponsored financial institutions (the farm credit system) agricultural lending increased from 32.6 percent to 48.1 percent of the total from 1970 to 1984 to meet agricultural finance needs. Commercial bank investors contracted agricultural lending from 1975 to 1980

from $28.9 billion to $22.1 billion when agricultural investment returns were favorable. It is inconceivable that private sector lenders will be attracted to agriculture with net farm income projected to continue to decline.

Governors recognize that significant adjustments in the agricultural sector will continue to occur given the ongoing agricultural economic recession. We do not advocate eliminating the new market orientation. However, policy efforts should be made which soften the adjustment process and prevent markets from overshooting long-term equilibrium levels. Incentives for private sector investment may be necessary to reverse the dominant federal role in agricultural credit markets.

The depressed agricultural economy and limited potential for deposit growth in rural communities are market signals which cause investors to withdraw capital. Commercial banks have only limited ability to pool agricultural risk because agricultural banks tend to be small and loan portfolios are not broadly diversified. Farm loan concentration is highest for commercial banks in the Midwest and Northern Plains states, and farm loan losses have been concentrated in ten states: California, Iowa, Nebraska, Montana, Missouri, Minnesota, South Dakota, Colorado, Kansas and Massachusetts. Net farm loan charge-offs range from 4.2 percent in California to 2.1 percent in Kansas. Governors believe that it is necessary to stabilize agricultural bank capital. We have three recommendations to deal with the immediate problem.

First, we recommend that federal bank regulators institute a loan loss deferral program, and there is a state model to emulate. The state of Arkansas enacted a law last March which allows banks in certain cases to charge off at five percent per year farm land acquired through foreclosures or through deeds of conveyance in lieu of foreclosure. A balloon charge off will occur at the end of a ten year period. Banks must petition the State Banking Commissioner for discretionary approval to qualify loans for stretchout write-offs. Governors support assistance for ailing farm loans held by commercial banks because we believe that the current agricultural recession is permanent.

Second, we recommend that relief similar to the relief provided for farm credit system should be provided for commercial banks who have put their own capital at risk. The Farm Credit System Relief Act authorities a corporation to buy problem farm loans or assets, thus increasing the liquidity of farm credit system banks. The corporation will lease the assets, enroll in federal farm program acreage programs and issue government-backed bonds to raise operating revenue. Governors believe that a study should be conducted to devise a means for the Federal Deposit Insurance Corporation to warehouse commercial bank farm loans through the Farm Credit System Capital Corporation. This approach could be most cost effective over the long run, and it would eliminate the arbitrary distinction between farm credit system banks and commercial banks. Quite frankly, Governors would have a hard time explaining to their citizens why we keep renegotiating foreign debt when we can't provide relief to American banks.

Finally, there is an immediate need for corrective legislation before hundreds of new "non-banks" reduce the deposit base of traditional institutions

and impair the primary source of investments in local communities. The National Governors' Association supports enactment of an appropriate cut-off date and operating restrictions for "grandfathered" institutions.

States have a role in assisting fundamentally sound farms and depository institutions during times of temporary financial distress. Dire predictions of farm and bank failures prompted fifteen Governors to offer twenty-two emergency financial assistance programs in 1985. While state expenditures under these emergency programs were relatively small in comparison to the total financial requirements of agriculture, over a half billion dollars were committed to almost 20,000 loans by states. This state commitment emphasizes our willingness to contribute toward temporary agricultural financial assistance. However, Governors do not believe that any federally mandated interest rate buy down program should be contingent upon state participation. Farm-belt states are in poor fiscal shape as a direct result of a deteriorating farm economy.

The Current Fiscal Condition of Farm-Belt States

Fortunes of farm-belt states cannot be separated from the financial condition of its farmers. Iowa and Nebraska have cut fiscal 1986 budgets and Nebraska raised taxes in a special session last November. Both Kansas and Nebraska Governors are proposing fiscal 1987 budgets that are smaller than the fiscal 1986 budget. And, Governors from the states of Arkansas, Idaho and Mississippi, who serve on the National Governors' Association Agriculture Committee, have had to cut their FY86 budgets twice.

Minnesota and Wisconsin also have large farm sectors in their economies and both have had to cut back sharply on current biennial expenditures. Both states are also projecting significantly lower economic growth for the remainder of the biennium. Farm state Governors must plan how they can best meet the needs of the citizens we represent during this agricultural recession.

The Importance of Early Congressional Action

Planting time is approaching once again in the food producing states. A Kansas City Federal Reserve Bank economist has predicted that 6 to 8 percent of the farm-belt producers will fail to get the financing they need to continue operating this year. Stabilization of agricultural borrowers should be approached with a sense of urgency. The National Governors' Association compliments this Committee for focusing on the agriculture credit issue at this time.

We join the Senate leadership in providing transition assistance for farmers and lenders because they had done much more for us and our rural communities and because it is the right thing to do.

Mr. Chairman, I would be happy to answer any questions.